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Samuel H. Liberman
Washington University

NORMALIZED TAXES IN UTILITY RATES: GIVING CREDITS WHEN NONE ARE DUE

SAMUEL H. LIBERMAN*

I. INTRODUCTION

Privately owned utility companies in recent years have spent an increasing share of the nation's new capital investment.[1] Electric power companies have raised large amounts of capital for new and replacement generating facilities,[2] including a number of costly nuclear facilities.[3] The market possibilities for public utility investment under existing regulatory law, however, are apparently not attractive enough to raise all the capital desired by the electric utility companies.[4]

A number of regulatory actions have been suggested and occasionally adopted to assist these companies in their efforts to raise capital. These include raising the rates of return on common

* Assistant Professor of Clinical Law, Washington University. A.B., Amherst College, LL.B. Harvard University. The author wishes to express his appreciation to David Newburger, Esq., and also to: Dale Swihart, Professor of Law; James A. Anderson, Associate Professor of Accounting; and, Edward L. Spitznagel, Jr., Associate Professor of Mathematics, all of Washington University. The author is also grateful to his research assistants, Richard Goldstein and Debbi Klopman.

1. Electric utilities accounted for 15.7% of industries' annual expenditures for new plant and equipment in 1974 as compared to 7.9% in 1964 and 5.3% in 1947. *See* U.S. DEP'T OF COMM., SURVEY OF CURRENT BUSINESS (statistical Supp. 1975). Under President Ford's energy plan for 1976-85, $750 billion or about ¾ of the net private domestic investment for the period, was to be in electrification. Lovins, *Energy Strategy: The Road Not Taken?*, 55 FOREIGN AFF. 65, 70 (1976).

2. M. WEIDENBAUM, FINANCING THE ELECTRIC UTILITY INDUSTRY, Pub. No. 1, Center for the Study of American Business 427, 443 (1975).

3. *Id.* at 429, 433, 463 *passim.*

4. *See Financial Problems of the Electric Utilities: Hearings on National Fuel and Energy Policy Study Before the Senate Comm. on Interior and Insular Affairs*, 93rd Cong., 2d Sess., 21, 38-40 (1974) (prepared statement of I. Stelzer and H. Roseman) [hereinafter cited as STUDY HEARINGS]. One can argue that the true cause for any difficulty in raising capital is the lack of proven existing or predictable demand for more power. *See id.* at 32. A 20% reserve margin for generating capacity is generally considered adequate. Critics point out that the electric power industry currently has a reserve margin of 30.5%, 31,408 megawatts in excess of a reasonable reserve. ENVIRONMENTAL ACTION FOUNDATION, UTILITY SCOREBOARD 11 (1978). A 37% figure has been published still more recently. ENVIRONMENTAL ACTION FOUNDATION, POWER LINE 6 (Nov. 1978). If investors do not feel that new capacity will result in increased sales, they will be reluctant to invest, since utility profits depend on generating enough sales to earn the full rate of return allowed on investment. See note 48 *infra,* discussing the alleged tendency to over capitalize in the public utility industry.

stock,[5] allowing companies to include construction work in progress in the rate base,[6] and permitting fuel adjustment clauses[7] to

5. A sufficient return on common stock is crucial to the electric utility industry. Many electric utility companies are close to a maximum leverage position, in which they cannot without impairing the security of bondholders issue more debt without issuing proportionate amounts of common stock. Sufficient earnings are needed to market the new common stock issues at prices above book value. STUDY HEARINGS, *supra* note 4, at 43-50; McDiarmid, *The Rise and Decline of Electric Utility Credit*, 95 PUB. UTIL. FORT. 19, 20 (1975). Regulatory commissions have directly responded to this need by increasing the allowed rate of return on equity. The average allowed rate of return on equity in state ratemaking decisions rose from 11.37% in 1970, *see* ARTHUR ANDERSEN & CO., STUDY OF RETURNS ALLOWED IN ELECTRIC UTILITY RATE CASES (August, 1972), to 13.14% in 1977; data supplied to the author by Edison Elec. Inst. (August, 1978). In each case the information is a simple average of the percent allowed in particular rate cases. It does not reflect allowed percentages in cases not occurring in the particular year. The average yield on Moody's 24 selected electric utilities rose from 5.94% in 1970 to 8.64% in 1976, perhaps reflecting the overall increase in the allowed rate of return. Moody's Nationwide Survey of Public Utility Progress 11 (1977).

6. This practice allows utilities to earn a return from ratepayers on plant not yet actually serving them. Although very popular with utility companies, its popularity with regulators may be on the wane. The Edison Electric Institute's Survey on Construction Work in Progress in Rate Base, updated to Jan. 1, 1978, shows 22 states allowing 100% of CWIP in the rate base, but this does not tell the whole story. The statistics reflect only the number of states where CWIP has been allowed in one or more cases. There may be other utilities in the same jurisdictions with no CWIP in the rate base. Although 14 state commissions allowed CWIP for the first time during 1974-76, since then there has been only one other state allowing CWIP, balanced by two states that revoked the former allowance. Statistics from the same source indicate that approximately 13 states allow no CWIP in the rate base, two allow only so much as will be operative within six months of the test year, two allow it only for environmental control facilities, and the remainder allow only a portion. Evidencing unusual public concern, CWIP has been prohibited by voter initiative in Missouri, MO. REV. STAT. § 393.135 (Vernon Supp. 1979), and Oregon, ORE. REV. STAT. § 757 (1978).

Statistics cited throughout this article regarding the number of jurisdictions that follow a particular ratemaking practice are not completely reliable for a number of reasons. A particular commission may use different rules in different cases or may depart from a general rule in a particular case. Generally, these statistics rely on the most recent decision, although the majority of companies or the companies serving the most customers may still be governed by a different rule, either because there has been no recent rate case or because in a rate increase proceeding the company may have settled for something less in one area in order to gain an advantage in another.

There are also definitional problems. For instance, is inclusion in the rate base of a plant that will be completed within the next year after the test year allowance of construction work in progress, or merely a *pro forma* adjustment for known changes? Commissions do not always agree. Although complete reliance on such statistics as these for current regulatory practices is unwise, they do reflect recent trends.

7. The Federal Power Commission and approximately 42 states had adopted automatic fuel adjustment clauses as of 1975, and, during 1974, these clauses accounted for 2/3 of the $8 billion in allowed electricity rate increases. Note, *Due Process Restraints on the Use of Automatic Adjustment Clauses in Utility Rate Schedules*, 18 ARIZ. L. REV. 453, 453 n.1 (1976) (citing SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS, HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, REPORT ON ELECTRIC UTILITY FUEL ADJUSTMENT CLAUSES,

ensure the faster recovery of increased fuel expenses and thus help utility companies keep earnings and cash flow levels higher during periods of rising fuel costs and inflation.

Congress has given substantial assistance to electric utility companies in the form of tax benefits, and has considered but not adopted a direct federal guarantee of electric utility bonds.[8] Congress has also assisted the utility companies in a way that entails less direct federal financial entanglement.[9] Electric power companies have been among the chief beneficiaries of several income tax subsidies designed to stimulate capital investment generally, particularly the use of more rapid methods of depreciation[10] and the allowance of investment tax credits.[11] Moreover, these companies may benefit from certain income tax accounting provisions that operate to create a subsidy even though none may have been intended. This occurs if the income tax law, whether federal or state, allows deduction of expenses that the utility is required to amortize for ratemaking purposes, resulting in a current tax deduction for the company. If the ratemaking body chooses to postpone the benefit of this tax deduction until the years in which the expense itself is actually being amortized, the company receives the present use of the money saved by the current tax deduction, again helping to raise capital internally.[12]

The effect of each type of tax benefit to a regulated utility company depends on the regulatory treatment given by the ratemaking body setting rates for each company. The different types of tax benefits are discussed separately below, but, generally, to

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94th Cong., 1st Sess., 1, 66 (Subcomm. Print 1975)). Of a projected $10.01 billion increase in electric and gas rates during 1977 $6.52 billion was added by fuel adjustment clauses. *Electric and Gas Utility Rate and Fuel Adjustment Clause Increases, 1977: Report on Fuel Adjustment Clause Increases to Subcomm. on Intergovernmental Relations and Subcomm. on Energy, Nuclear Proliferation and Federal Services of the Senate Comm. on Governmental Affairs,* 95th Cong., 2d Sess. (1978). (The suggested 51% of pending electric rate increase applications has been used to arrive at a projected total.)

The Federal Power Commission, frequently referred to in this article, was abolished as a separate department, and a new Federal Energy Regulatory Commission established within the Department of the Interior in 1977. 42 U.S.C.A. § 7171 (Supp. 1977). This article at all times refers to the old Federal Power Commission, sometimes abbreviated FPC, when that agency was the author of any action, rule, or opinion pertaining to the subject.

8. M. WEIDENBAUM, *supra* note 2, at 430-31.

9. *See* STUDY HEARINGS, *supra* note 4, at 66-70, 75, suggesting a preference for normalization of tax benefits to direct federal loan guaranties.

10. I.R.C. § 167(b)(2)-(4) discussed in Part II. A., *infra.*

11. I.R.C. § 46, discussed in Part IV, *infra.*

12. See discussion in Part III, *infra.*

the extent that a current tax benefit is "flowed through" the utility's rates, the company receives a different kind of benefit than if they are "normalized."[13] If a tax benefit is flowed through, the ratemaking body simply deducts an amount equal to the tax benefit from the revenue allowed to be recovered by the company. The company receives only the benefits attached to lower prices, such as customer goodwill and possible larger sales based on elasticity of demand. On the other hand, if a tax benefit is deferred or normalized, the regulatory authority is allowing the current customers to be charged for a fictitious tax; hence, the company, and its stockholders, receive a more tangible benefit in the form of increased cash on hand, usable as internally generated capital, at least until the deferred tax is actually paid to the government. In 1974, the amount of federal income taxes that the 150 largest investor owned electric utilities charged their customers was 1.47 billion dollars in excess of the amount of taxes actually paid, lowering the taxes paid to 8.17% of their taxable income.[14] By 1976 the deferred tax excess for the 100 largest companies was up to 2.08 billion dollars while their actual tax bill was only 37.4 million dollars, and thirty of them paid no tax at all.[15] For all Class A & B electrical utilities, federal income taxes dropped from 14.7% of revenue in 1955 to 1.3% in 1975.[16] Congress has allowed further increases in the tax benefits for future years.[17] Consequently, "normalization" has emerged as a major factor in utility ratemaking.

The remainder of Part I of this article briefly describes the ratemaking process and the effect of normalization. Part II.A. discusses normalization of accelerated depreciation, its history, and the initial responses of ratemaking bodies. Part II.B. focuses on the Internal Revenue Code amendment creating Section 167(*l*), which in most situations requires normalization of tax

13. "Normalization" describes a method of handling such tax benefits by deferring them to later years. Arguably, the process does not achieve normality and therefore normalization is a misleading term. Although normalization seems to mean something slightly different for each type of tax benefit, a common element is that in each case the normalized tax benefit is not immediately "flowed through," *i.e.*, passed on directly to the ratepayers in the form of lower rates.

14. ENVIRONMENTAL ACTION FOUNDATION, PHANTOM TAXES IN YOUR ELECTRIC BILL 26 (1976).

15. ENVIRONMENTAL ACTION FOUNDATION, UTILITY SCOREBOARD 16 (1978).

16. 123 CONG. REC., S13,931-32 (daily ed. Aug. 5, 1977) (remarks of Sen. Metcalf).

17. *See* note 202 and accompanying text *infra*, for a discussion of the additional liberalization and extension of the investment tax credit.

benefits derived from accelerated depreciation, and discusses the various misunderstandings that led to this result. Part II.C. compares a related form of accelerated depreciation obtained by shortening the useful life of property for tax depreciation. Part II.D. evaluates the various legal and policy arguments concerning normalization versus flow-through of accelerated depreciation tax benefits. Taken together, Part II develops the argument against normalization, using accelerated depreciation tax benefits as a prototype. Part III discusses "Comprehensive Interperiod Income Tax Allocation" and the normalization of benefits resulting from current tax expense deductions relating to items that must be amortized for rate purposes. Part IV describes the normalization problems associated with investment tax credits. Finally, Part V suggests that the relevant statutory and constitutional standards prohibit normalization, despite those Internal Revenue Code sections that would otherwise require it.

In discussing the operation and effect of these tax benefits, the following ratemaking model is utilized: $R=(r \times B)+E$. In this equation, "R" is the revenue a regulatory authority allows to be earned over a year; "r" is the rate of return on capital, which is a percentage usually consisting of a weighted average of the actual cost of embedded debt and a reasonable rate of return on equity; "B" is the rate base, usually those assets of the company used and usable in the provision of service to its customers;[18] and "E" is the operating expenses, including depreciation allowance and taxes. Almost all regulatory authorities set rates according to a formula similar to this, which is applied to data collected or estimated for a "test year," a period of 12 months operation of a company.[19] The many additional complications of this formula are irrelevant to this discussion and other methods of setting rates will not be treated because variations of this method are so commonly in use. In setting rates, the regulatory authorities must determine whether the tax benefits described above should be flowed through to the ratepayers by corresponding reductions in the operating expense section of the formula, reducing the amount of revenue allowed to be collected by the companies, or whether the amount of reduced taxes should be normalized, pro-

18. This was the general rule prior to the allowance of construction work in progress in the rate base and is still the rule in many jurisdictions. *E.g.*, Newport Gas & Light Co., 85 PUB. U. REP. 3d (PUR) 257, 259 (R.I. P.U.C. 1970).

19. For a recent verbalization of the ratemaking formula, see New England Tel. & Tel. Co. v. Public Utils. Comm'n, 390 A.2d 8, 14 (Me. 1978).

ducing at least a temporary source of investment capital for the company. Additionally, the existence of this tax-free capital may be recognized by reducing either the rate of return or the rate base upon which a rate of return is allowed. The regulatory task is further complicated by provisions in the tax code which purport to deny some of these tax benefits unless they are normalized.[20]

In applying a formula such as this, regulatory bodies have broad discretion. This article takes the position that courts and ratemaking bodies must interpret certain legal requirements and legal issues in determining the correct treatment of these tax benefits for setting utility rates. Arguably there are no longer any substantive due process restraints on economic regulation,[21] and a regulatory authority can constitutionally set whatever rates it desires. Nevertheless, courts continue to hold that setting the revenue requirement too low will deprive the utility company of its property without due process of law, implying a corresponding constitutional duty to ratepayers not to set the revenues too high. Similar statutory standards govern rate determinations, requiring that rates be "just and reasonable" while at the same time providing a fair return, including allowance for surplus and contingencies.[22]

The argument against the allowance of normalized taxes as a cost of service rests on the theory that the allowance of unjustified expenses results in unlawful excess earnings to the company in violation of these constitutional and statutory standards. Thus, the legal purposes and methods of ratemaking require that current tax benefits be passed through as much as possible to the current ratepayers, and contrary ratemaking practices are inconsistent with these purposes. Since Congress has prohibited or limited flow-through in at least two instances, the validity of congressional use of the taxing power in this area must be scrutinized. To the extent that the tax laws create a rate subsidy, Congress has taken over state regulation of rates; arguably, the taxing power may not unduly interfere with a state regulatory scheme. Moreover, by requiring the regulatory authorities to allow fictitious expenses, Congress has created unreasonably high

20. I.R.C. §§ 167(*l*), 46(f).

21. *E.g.*, Olsen v. Nebraska, 313 U.S. 236 (1941); Nebbia v. New York, 291 U.S. 502 (1934).

22. *E.g.*, ME. REV. STAT., tit. 51 § 35; 47 N.Y. [PUB. SERV.] LAWS (consol.) §§ 65.1, 72. See also Part V.A., *infra*.

revenue returns to the utility companies in violation of the constitutional precepts set down by the Supreme Court.[23]

II. Normalization Of Tax Benefits Related To Depreciation

A. *Accelerated Depreciation*

Accelerated depreciation is considered first because it has been the subject of the most consideration by courts and commissions. The discussion of accelerated depreciation in Section II will include most of the factors applicable to the other types of deferred tax benefits as well.

The first of these general factors applying to all normalization is simply recognition of the problems incurred by using the Internal Revenue Code to subsidize certain activities within the nation's economy. It has been argued powerfully that this is a form of subsidization that is inherently suspect, and a heavy burden of proving the preferability of a tax subsidy to a direct grant should be placed on tax subsidy proponents.[24] The primary arguments against such subsidies are that although they cost the taxpayers just as much as a direct grant they are not generally considered as part of a budget,[25] and they are not developed by committees or administered by agencies that have expertise in the substantive area to which they pertain.[26] Further, the subsidies are not likely to accomplish the governmental objective as cheaply as possible because they tend to create windfalls,[27] they create inequities within the tax structure,[28] and they confuse the tax system.[29] Congress, however, continues to use these methods of subsidy. It may actually be easier to enact and continue a tax incentive than it is to furnish a direct grant precisely because the amount of the benefit is not calculated or listed in the federal budget, and because the benefit comes with limited or ineffective federal regulation.

Accelerated depreciation was initially enacted as a stimulus to equipment and machinery investments as part of the Internal

23. These arguments are developed in Parts V.A. and V.B., *infra.*

24. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures,* 83 Harv. L. Rev. 705, 734 (1970).

25. *Id.* at 729-31.

26. *Id.* at 728-29.

27. *Id.* at 719-20.

28. *Id.* at 720-25.

29. *Id.* at 731.

Revenue Code of 1954.[30] Undoubtedly, a direct grant to all firms allowing the purchase of new equipment and machinery would have been very difficult to enact or administer, even if constitutional. Assuming it could be done, tax problems would still be associated with a direct grant. For example, should a direct grant be taxable as income in the year received or treated as a nontaxable gift or contribution to capital,[31] and should future depreciation expense deductions be allowed?[32]

For whatever reasons, Congress proceeded via a tax subsidy. Problems may arise from grants made in this form simply because the subsidy is tied to something already within the tax structure. In this case the benefit is tied to depreciation, which is itself a complicated subject.[33] All depreciation is a fictitious expense in the sense that no cash payments are made or allocated. The concept of depreciation is predicated on the impermanence of equipment and plant purchased for use in a business which results from physical wear and tear (the effects of use, chemical action, wind, heat, cold, etc.) and functional variables (obsolescence, changed operating conditions, etc.).[34] Since a firm's capital is invested in these assets, the capital would in a sense eventually be used up by this physical and functional degeneration, unless sufficient income is earned to replace it. Viewed in one way, earnings are overstated unless depreciation is considered, because the capital would be depleted in the process of operating. Viewed another way, earnings are understated by taking depreciation, because a company is earning not only its stated return but an additional amount to maintain or replace its capital. However one views the questions, it is now generally accepted that physical assets wear out or become obsolete, and therefore some form of depreciation should be recognized in accounting for financial operations.

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30. I.R.C. § 167; *see* Swiren, *Accelerated Depreciation Tax Benefits in Utility Rate Making*, 28 U. CHI. L. REV. 629, 629-30 (1961) [hereinafter cited as Swiren].

31. *See* Frolik, *Section 118 and the Tax Treatment of Nonshareholder Contribution to Capital*, 38 OHIO ST. L.J. 499 (1977), for a general discussion of taxability of nonshareholder contributions, including governmental grants.

32. *Id.* at 524-25 (discussing I.R.C. § 118(b), which requires customers' contributions in aid of construction to water and sewage companies to be treated as nontaxable capital contributions and denies depreciation or investment tax credit for federal income tax purposes).

33. *See generally* J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 192-223 (1961).

34. P. MASON, PRINCIPLES OF PUBLIC UTILITY DEPRECIATION, AMERICAN ACCOUNTING ASSOCIATION MONOGRAPH NO. 1, 2 (1937).

Although recognition of depreciation expense does not produce any cash flow,[35] it does suggest in a rough way this consumption of assets, particularly since the accumulated depreciation must be shown on the balance sheet either as a liability or as a set-off to the assets in question. To the extent earnings are sufficient, a firm is likely to retain a portion of them to balance the loss of asset value from this depreciation.

The depreciation allowance itself does not correspond precisely to the amount of wear and tear or obsolescence, but it is generally calculated by estimating the useful life of an asset, and dividing its net cost (usually original cost less estimated salvage value) in some rational manner over, the years of the useful life of the asset.[36] This results in an apportionment of the total expense over a period that relates to the service life of each asset. The most common method is straight-line depreciation which allocates the depreciation expense into an equal amount for each year of the life of the asset.[37]

The most common alternatives to straight-line depreciation are double-declining balance and sum-of-the-years' digits methods, each of which increases substantially the amount of depreciation claimed in earlier years and decreases it in later years relative to straight-line depreciation.[38] The popularity of these methods is largely a consequence of their acceptance in the Internal Revenue Code.[39] In some instances these alternatives may be employed because the equipment is actually used more in its earlier years and therefore allocating more of the expense to these years is proper, tax considerations aside.[40]

Although a strong argument can be made against tax recognition of depreciation because earnings used to replace capital are just as much income as earnings used to pay dividends, depreciation has for some time been recognized as a deductible expense for tax purposes.[41] Assuming that depreciation is to be an allow-

35. G. THOMPSON, R. WHITEMAN, E. PHILLIPS & W. WARREN, ACCOUNTING AND THE LAW 355 (4th ed. 1978) [hereinafter cited as G. THOMPSON].

36. *Id.* at 356. It is also possible to handle depreciation on a unit basis or by simply observing wear and tear; however, these methods are rarely used. *Id.* at 358-59.

37. *Id.* at 356.

38. *Id.* at 357-58. See I.R.C. § 167(b)(2)-(3). The Internal Revenue Service also allows acceleration of depreciation by shortening for tax purposes the estimated useful lives of certain assets. See Part II.*C., infra.*

39. G. THOMPSON, *supra* note 35, at 357.

40. Swiren, *supra* note 30, at 629-30.

41. Depreciation was apparently prohibited as an expense in the Income Act of 1894,

able tax deduction, there is no sound reason why it should not be allowed to utility companies as well as other businesses.

The use of more rapid income tax depreciation as a stimulus to investment in plant and equipment, however, raises certain theoretical problems. Logically, regulated industries should not receive subsidies such as accelerated depreciation. Since regulated businesses exist and are given monopoly privileges in return for meeting a public demand, their output and growth should relate to and be governed by that demand. If the capital expenditures of utility companies generated by liberalized depreciation exceeds that required by public demand, the consumer will have to bear the expense of this unnecessary plant expansion. Since regulated utilities have a duty to supply all reasonable customer demand within their service area,[42] they will have to build necessary plant addition anyway, and the commissions are required to let them earn enough to attract the necessary capital.[43] Therefore, any further subsidy is misplaced and creates a windfall.

Congress has, however, included regulated utilities among the beneficiaries of this tax reduction.[44] The original inclusion of regulated companies may have resulted in part from their inclusion as beneficiaries of earlier income tax provisions allowing accelerated amortization of the construction costs of certain facilities certified by the proper defense agency as urgently necessary.[45] Since the Korean War effort required more electric plant construction to provide power for the production of military equip-

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Act of Aug. 27, 1894, ch. 349, § 28, 28 Stat. 509, 553, which was later held unconstitutional in Pollock v. Farmers Loan & Tr. Co., 158 U.S. 601 (1895). Depreciation was not mentioned in six earlier tax laws, but was allowed as a deduction by the Tariff Act of 1913, ch. 16, § II(B), (G)(b) 38 Stat. 167, 172, and by subsequent acts. See Lischer, *Depreciation Policy: Whither Thou Goest*, 32 S.W.L.J. 545, 550-51 (1978).

42. 1 A. PRIEST, PRINCIPLES OF PUBLIC UTILITY REGULATION 227-33 (1969). *E.g.*, United Fuel Gas Co. v. Railroad Comm'n, 278 U.S. 300, 309 (1929); Messer v. S. Airways Sales Co., 245 Ala. 462, 17 So. 2d 679 (1944); IOWA CODE ANN. § 490A(3) (Supp. 1978); N.Y. [PUB. SERV.] LAW (consol.) § 65; WIS. STAT. ANN. tit. 17, § 196.03(1) (West 1957).

43. The building of new plants is required if necessary to meet customer demand and is subject to state licensing regulation. *E.g.*, N.Y. [PUB. SERV.] LAW (consol.) § 66. Moreover, the regulators must see to it that rates provide sufficient earnings to enable the company to raise capital needed for new plants. *E.g.*, The United Fuel Gas Co., 46 PUB. U. REP. 3d (PUR) 118, 123 (W. Va. P.S.C. 1962), ME. REV. STAT. tit. 35, § 51.

44. Apparently Congress did not initially give any particular consideration to the effect on or applicability of accelerated depreciation to regulated industries. Swiren, *supra* note 30, at 631.

45. Int. Rev. Code of 1939, Ch. 2, § 23(t), 54 Stat. 996 (later I.R.C. § 168, repealed Pub. L. No. 94-455, tit. XIX, § 1951(b)(4)(A), 90 Stat. 1837 (1976)). Although this section was not repealed until 1976, no new certifications were made after 1959.

ment and since the emergency need for these facilities required very rapid expansion of plants, the inclusion of electric utilities within the scope of this tax subsidy to provide cash flow more quickly than could be done through the normal rate procedures is arguably more defensible. This argument applies with less force, if at all, to Section 167 accelerated depreciation, which does not originate from the same kind of emergency.[46]

An argument for allowing accelerated depreciation to utilities may be based on welfare grounds; by subsidizing the utilities, Congress, if not stimulating investment, is at least keeping utility prices down. The validity of this argument, however, depends largely on subsequent ratemaking decisions. To the extent that normalization defers or eliminates the benefits, the current ratepayers are not helped.[47] Moreover, any tax savings currently or ultimately passed on to ratepayers will be harmful if the incentive stimulates construction of unnecessary facilities. The tax savings in expenses will be equalled or overshadowed by the higher rates of return needed to attract the capital for such construction. Other incentives for overexpansion already exist in the utility regulatory system itself, aside from tax benefits.[48] If the purpose is lower rates, the ratepayers would derive greater assistance from simply lowering or removing the taxes on utilities without attaching these benefits to construction programs, or by awarding the

46. *See* Pennsylvania Pub. Utils. Comm'n v. Citizens Water Co., 13 PUB. U. REP. 3d (PUR) 189, 220 (Pa. P.U.C. 1955). Swiren argues to the contrary that there is no discernible distinction between the cases allowing normalization of the wartime facilities amortization and those allowing accelerated depreciation benefits under I.R.C. § 167. Swiren, *supra* note 30, at 647.

47. It has also been demonstrated by mathematical simulation that under growth conditions, normalization results in higher electric rate charges to consumers than flow-through. Brigham, *The Effects of Alternative Tax Depreciation Policies on Public Utility Rate Structure*, 20 NAT. TAX J. 204, 213 (1967); E. BRIGHAM & J. PAPPAS, LIBERALIZED DEPRECIATION AND CAPITAL COSTS 86-91 (1970). Brigham and Pappas also conclude, however, that flow-through treatment results in higher cost of capital. *Id.* at 92.

48. Arguably, regulated firms tend to over build in general. Since profits are regulated the managerial incentives lie in growth of sales rather than growth of profits. In addition, the regulatory system itself may encourage unnecessary expansion. *See* Averch and Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 AM. ECON. REV. 10, 52 (1962). The legal requirement that commissions grant a reasonable return on investment causes utility company management to make that investment in situations where a competing firm would hesitate. E. BERLIN, C. CICHETTI & W. GILLEN, PERSPECTIVE ON POWER 59-60 (1974); 2 A. KAHN, THE ECONOMICS OF REGULATION 50-54 (1971). The Averch-Johnson thesis has been supported by empirical studies confirming the overcapitalization hypothesis. Spann, *Rate of Return Regulation and Efficiency in Production: An Empirical Test of the Averch-Johnson Thesis*, 5 BELL J. 35 (1974).

benefits only to the utilities that do not overbuild.[49]

Satisfactory policy grounds for granting accelerated depreciation tax benefits to utilities are difficult to find. Congress, however, has not only continued to allow utilities to take accelerated depreciation for tax purposes, but has specifically recognized it and has all but required normalization, thereby preventing the tax benefits from being flowed through to the current ratepayers.[50]

From its inception, accelerated depreciation for tax purposes proved irresistable to many utilities because of their heavy investment in new and replacement equipment.[51] If a utility company elected to accept the tax benefits of accelerated depreciation, the regulatory handling of the tax benefit raised a ratemaking problem. Although there was a flurry of normalization at the beginning, over the early period as a whole many regulators took the position that the benefits had to be flowed through to ratepayers because a company could not claim any more tax expense than its actual tax liability.[52] Many companies, however, preferred to

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49. The late Senator Lee Metcalf became so alarmed at normalization that starting in 1975 he advocated eliminating the federal income tax on utilities altogether. *See* S. 2028, 95th Cong., 1st Sess., 123 CONG. REC. 13,931-33 (Aug. 5, 1977), introduced by Metcalf, and H.R. 8897, 95th Cong., 1st Sess., 123 CONG. REC. 8779 (Aug. 5, 1977), introduced by Rep. Stark, which would exempt privately owned electric utilities from federal income tax on utility operations and replace the tax with an excise on kilowatt hour usage. The idea of eliminating or reducing taxes on utilities is not a new one. Since the utilities exist to provide services deemed necessary to the public, an argument can be made that taxing them is simply raising the cost of necessary services. Arguably, however, the tax on utilities should not differ from that imposed on nonutilities, lest an improper allocation of resources result. J. BONBRIGHT, *supra* note 33, at 404; C. PHILLIPS, THE ECONOMICS OF THE REGULATION 211 (1969).

Although much electricity may be used for purposes of luxury and for the production of unnecessary goods or services, there is a certain portion that is used for basic necessities such as light and refrigeration. Phillips suggests that since industrial customers are more elastic than residential customers in their demand for electricity, industrial rates tend to be lower, causing a larger percentage of the tax burden to fall on residential customers. *Id.* at 210.

50. See Part II.B. *infra*.

51. Swiren, *supra* note 30, at 630; *What Others Think: Thoughts on Accelerated Depreciation*, 62 PUB. UTIL. FORT. 265 (Aug. 14, 1958), stating that 64 out of 80 companies used accelerated depreciation only four years after its enactment.

52. Central Maine Power Co. v. Public Util. Comm'n, 153 Me. 228, 136 A.2d 726 (1957) (refusing to read § 167 as providing interest-free loans from the ratepayers through present payment of deferred tax); Joplin Water Works Co., 20 PUB. U. REP. 3d (PUR) 195, 203 (Mo. P.S.C. 1957) (commission not authorized to allow more than the actual test year income tax liability as an operating expense); Public Service Co. of New Hampshire, 18 PUB. U. REP. 3d (PUR) 523 (N.H.P.U.C. 1957) (taxes actually paid are the proper expense); Plainfield Union Water Co., 57 N.J. Super. 158, 154 A.2d 201 (1959); Lea County

normalize the taxes by collecting revenue from the ratepayers in early years and creating a reserve account to pay the heavier taxes that might result in later years. This confers an advantage on the company and the stockholders by giving them the free use of the ratepayers' money until the additional taxes are due. In its ideal form, from the investors' view, this ratepayer capital from deferred taxes could earn further money by its inclusion in the company rate base that determines the amount of return.[53] A third, compromise view was that the deferred taxes would be allowed as an expense, but excluded from rate base or not allowed to earn a return.[54] This view later prevailed in most jurisdictions, after a series of developments had led to further changes in the Internal Revenue Code favoring normalization.

B. Congressional Action Limiting Availability of Accelerated Depreciation Unless Normalized

In 1957, the Maine Public Utilities Commission disallowed normalization.[55] Subsequently, a Maine utility elected to discontinue using accelerated depreciation for taxes. In a rate increase

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Gas Co., 10 PUB. U. REP. 3d (PUR) 279, 289 (N.M.P.S.C. 1955) (normalization would require current ratepayers to bear more than their fair share of cost of plant); Pennsylvania Pub. Util. Comm'n v. Citizens Water Co., 13 PUB. U. REP. 3d (PUR) 189, 222 (Pa. P.U.C. 1955) (disallowing normalization because principal purpose of liberalized depreciation was not particularly applicable to regulated public utilities). *Contra,* Public Serv. Co. of Indiana, Inc., 12 PUB. U. REP. 3d (PUR) 509, 515 (Ind. P.S.C. 1956) (Congress intended to stimulate expansion of industry by providing interest-free loans); Western Kentucky Gas Co., 21 PUB. U. REP. 3d (PUR) 394, 399 (Ky. P.S.C. 1957); Amere Gas Utilities Co., 15 PUB. U. REP. 3d (PUR) 339 (F.P.C. 1956); Oklahoma Nat. Gas Co., 12 PUB. U. REP. 3d (PUR) 293, 295 (Okla. Corp. Comm'n. 1955).

53. J. BONBRIGHT, *supra* note 33, at 220. The FPC for a time allowed inclusion in rate base of all plants and equipment purchased with funds from the deferred tax reserve. *Re Treatment of Federal Income Taxes Affected by Accelerated Amortization,* 2 PUB. U. REP. 3d (PUR) 41, 45 (F.P.C. 1953) (concerning I.R.C. § 168 benefits); *accord,* Panhandle Eastern Pipe Line Co., 3 PUB. U. REP. 3d (PUR) 396, 429 (F.P.C. 1954) (concerning I.R.C. § 167 accelerated depreciation benefits); Public Serv. Co. of Indiana, 12 PUB. U. REP. 3d (PUR) 509 (Ind. P.S.C. 1956) (concerning accelerated depreciation). At a later time the FPC allowed a reduced rate of return of 1.5% on capital generated by the deferred tax reserve. Northern Nat. Gas Co., 38 PUB. U. REP. 3d (PUR) 149 (F.P.C. 1961); Panhandle Eastern Pipe Line Co., 25 F.P.C. 550 (1961), *aff'd sub nom.,* Panhandle Eastern Pipe Line Co. v. Federal Power Comm'n, 316 F.2d 659 (D.C. Cir. 1963). Still later the FPC allowed no return at all. See note 81 *infra.*

54. *E.g.,* Western Kentucky Gas Co., 21 PUB. U. REP. 3d (PUR) 394, 399 (Ky. P.S.C. 1957).

55. Central Maine Power Co., 17 PUB. U. REP. 3d (PUR) 452 (Me. P.U.C. 1957), *aff'd sub nom.,* Central Maine Power Co. v. Maine Pub. Utils. Comm'n, 153 Me. 288, 136 A.2d 726 (1957).

proceeding, the commission refused to allow the increased taxes incurred by the company's use of straight-line depreciation as proper costs of service, stating:

> rate regulation cannot be frustrated by a requirement imposing extravagant or unnecessary costs on ratepayers. Acker v. United States (1936) 298 U.S. 426, 430. . . . In this proceeding we are convinced that a tax savings, which may be availed of without any risk, is available to management. Commissions have frequently made hypothetical adjustments to debt ratios in test year computations for ratemaking purposes. In the same light we believe that the revenue requirements of Bangor Hydro should be computed to reflect the use of accelerated depreciation even though the company elects to pay a higher tax than it is liable for. Under the facts of this case, we would be remiss in the exercise of our paramount function of rate-making were we to decide otherwise.[56]

California was the first state to actually impute accelerated depreciation with flow-through to a company which had never taken accelerated depreciation for taxes at all.[57] Other jurisdictions adopted this approach, refusing to allow full actual taxes as an expense when a company utilized straight-line depreciation on the grounds that the company's management was not using its best judgment to minimize costs and therefore the rates including the higher tax costs were not just and reasonable.[58] Meanwhile, the Federal Power Commission (FPC) reversed its original position favoring normalization[59] to one favoring flow-through in the

56. Bangor Hydro-Electric Co., 26 PUB. U. REP. 3d (PUR) 489, 494-95 (Me. P.U.C. 1958). *See also* Glassman, *Objections to Taking Liberalized Depreciation*, 77 PUB. UTIL. FORT. 29, 37 (1966); Lewis, *The Duty of a Public Utility to Reduce Its Income Tax Liability by Using Accelerated Depreciation*, 35 LAND ECON. 104-14 (1958).

57. General Tel. Co. of Cal., 80 PUB. U. REP. 3d (PUR) 2, 50-51 (Cal. P.U.C. 1969); Pacific Tel. & Tel. Co., 77 PUB. U. REP. 3d (PUR) 1 (Cal. P.U.C. 1968).

58. *E.g.*, Colorado Mun. League v. Colorado Pub. Util. Comm'n, 172 Colo. 188, 473 P.2d 960 (1970), *reversing in part*, Mountain States Tel. & Tel. Co., 76 PUB. U. REP. 3d (PUR) 481 (Colo. P.U.C. 1969); Southern New England Tel. Co., 78 PUB. U. REP. 3d (PUR) 504, 520 (Conn. P.U.C. 1969). Utah recognized the desirability of using accelerated depreciation to reduce rates but did not directly impute such benefits. Mountain Fuel Supply Co., 76 PUB. U. REP. 3d (PUR) 277, 288 (Utah P.S.C. 1968). New York indicated a preference for accelerated depreciation with normalization over straight-line, but declined to do more than take into consideration the utility's refusal to adopt accelerated depreciation in setting its rate of return. New York Tel. Co., 84 PUB. U. REP. 3d (PUR) 321 (N.Y.P.S.C. 1970).

59. El Paso Nat. Gas Co., 29 PUB. U. REP. 3d (PUR) 469 (F.P.C. 1959), *aff'd sub nom.*, El Paso Nat. Gas Co. v. Federal Power Comm'n, 281 F.2d 567 (5th Cir. 1960); Amere Gas Utils. Co., 15 PUB. U. REP. 3d (PUR) 339 (F.P.C. 1956).

Alabama-Tennessee Natural Gas Co. case,[60] and it thereafter prohibited a natural gas company from switching back to straight-line depreciation for taxes.[61] Ironically, the regulatory commissions helped create a situation in which utilities were forced to take advantage of a tax subsidy that never should have been applicable to them in the first place. In doing so, the commissions probably correctly applied the law, but they also created pressure for a change in the law.

Congress amended Section 167 in 1969.[62] Congress was apparently concerned about loss of revenue from utilities flowing through the tax deduction and thus lowering their taxable income.[63] A loss of revenue in granting a tax benefit such as this, however, would appear to be foreseeable by Congress. On the other hand, as stated above, this tax loss is not justified because of the windfall nature of the tax benefits for utilities.[64] This problem could be resolved easily by prohibiting utilities from employing accelerated depreciation.[65] Instead, Congress extended the subsidy, but, to a great extent, required normalization. Because this and similar legislation requiring normalization may result from a misunderstanding, the concept behind this legislative history is discussed in detail here before considering the legislation itself.

Up to this point, some utility companies had elected to remain on straight-line depreciation because of the unpredictable regulatory results and a fear of heavy tax loads in later years if flow-through should be required. These companies, including the Bell System, naturally felt it unfair for a commission to impute the tax benefits of accelerated depreciation to them, and they were perhaps justified in seeking relief from Congress. Unfortunately, the form of the relief enacted—mandatory normalization—rested and probably still rests on the mistaken contention

60. 31 F.P.C. 208 (F.P.C. 1964), *aff'd sub nom.*, Alabama-Tennessee Nat. Gas Co. v. F.P.C., 359 F.2d 318 (5th Cir. 1966), *cert. denied*, 385 U.S. 847 (1966).

61. Midwestern Gas Transmission Co. v. Federal Power Comm'n, 388 F.2d 44 (7th Cir. 1968), *cert. denied*, 392 U.S. 928 (1968). *See generally* Welch, *Washington Outlook for Utilities in 1969*, 83 PUB. UTIL. FORT. 15, 18 (Jan. 16, 1969).

62. Int. Rev. Code of 1969, § 441, 83 Stat. 625 (now I.R.C. § 167(*l*)).

63. H. REP. No. 413, 91st Cong., 1st Sess. 132 (1969); S. REP. No. 552, 91st Cong., 1st Sess. 172 (1969).

64. *See* note 43 and accompanying text *supra*.

65. The FPC itself recommended this in *Amere*, 15 PUB. U. REP. 3d (PUR) 339, 340 (F.P.C. 1956) although at that time it felt bound to allow accelerated depreciation.

that the Treasury suffers a double loss of taxes if flow-through is used.

In setting rates, a commission must grant a rate sufficient to obtain the desired net revenue after taxes. If current revenues are deficient, the commission must grant an increase in double the amount of the deficiency to allow for an approximate fifty percent tax rate on all new dollars of revenue allowed. If this computation is made after all other expenses have been "netted out," it might appear that by flowing through the extra tax deduction a commission effectively lowers the rates by the amount of the deduction plus an approximately equal amount to pay the income taxes while still leaving the company with the allowed increase. Although this could possibly happen, it is largely a matter of computation. If the commission computes the amount of taxes by increasing the amount of the depreciation deduction only once, there is no double loss of dollars to the Treasury, and this becomes a false issue.

In lobbying for the 1969 amendment, the Bell System relied heavily on this alleged double tax loss. Its primary witness, Robert R. Nathan, stated that under flow-through regulatory practice, the tax deferral is viewed as additional earnings. Further, since at a fifty percent tax rate it takes revenue equal to twice the benefit to earn it net of taxes, he stated that the regulators feel free to reduce revenue by twice the tax, causing the government to lose twice the amount of taxes that it would lose if just the amount of the benefit was deducted from allowed revenue.[66] Mr. Nathan admitted that there is no "double loss" if the commission simply flows through the tax benefit.[67] His statement that the regulatory commissions feel free to reduce revenue by twice the tax benefit is unsupported and appears to be incorrect.[68]

The regulatory commissions generally compute the revenue requirement by calculating the necessary net return after taxes and simply doubling the dollar result to account for a fifty percent tax rate. This calculation involves the "$r \times B$" section of the

66. *Proposed Tax Reform Act: Hearings on H.R. 10 Before the Comm. on Ways and Means*, 91st Cong., 1st Sess., 3655, 3665-66, 3695-96 (1968) (statement of Robert R. Nathan) [hereinafter cited as Nathan]. *See also Proposed Tax Reform Act: Hearing on H.R. 5 Before the Senate Committee on Finance*, 91st Cong., 1st Sess., H.R. 13270, 4979 (1969) (letter of A.L. Stott, V.P. and comptroller of AT&T, to Chairman Long).

67. Nathan, *supra* note 66, at 3696.

68. Conversations in March and April 1978 with K. Turner, then a staff member of the Missouri P.S.C. indicated that in practice the tax benefits under flow-through ratemaking are only deducted once. The reasons are developed in the text.

formula. Expenses that are deductible for tax purposes are simply added at their face value to arrive at the appropriate gross revenue requirement. To the extent that an item of expense is included in the required revenue that is not deductible for tax purposes, it must also be doubled because it will be taxed. Items that are deductible for tax purposes, but not included as costs of service for rate purposes, can easily be accounted for by simply reducing the tax already calculated. Mr. Nathan set forth the following ostensibly plausible examples:

Examples of Doubling Effect of Flow-Through

Assume: Rate base $1,000
Tax rate 50%

Example I — Straight-line depreciation, book and tax

	Books	Tax
1. Revenues	$260	$260
2. Depreciation	100	100
3. Income before tax (1-2)	160	160
4. Tax	80	80
5. Earnings (3-4)	80	
6. Rate of return on $1,000 rate base	8%	

Example II — Assume an additional $40 of tax depreciation is deducted, with normalization

	Books	Tax
1. Revenues	$260	$260
2. Depreciation	100	140
3. Reserved for deferred tax (normalization)	20	
4. Income before tax (1—2+3)	140	120
5. Tax	60	60
6. Earnings (4—5)	80	
7. Return on $1,000 rate base	8%	

Example III — Assume an additional $40 of tax depreciation is deducted, with flow-through

	Books	Tax
1. Revenues	$260	$260
2. Depreciation	100	140
3. Income before tax (1—2)	160	120
4. Tax	60	60
5. Earnings (3—4)	100	
6. Rate of return on $1,000 rate base	10%	

If a 10% rate of return is deemed proper, then there would be no doubling effect from flow-through. It would mean, of course, that in order to obtain this permissable [sic] 10% rate of return, the company had to use up its tax basis prematurely in order to generate the

additional cash flow, and then treat that cash flow as the equivalent of earnings.

Example IV — Same as Example III, except revenues and taxes are reduced to produce a rate of retun [sic] of 8%.

	Books	Tax
1. Revnues [sic]	$220	$220
2. Depreciation	100	140
3. Income before tax (1—2)	120	80
4. Tax	40	40
5. Earnings (3—4)	80	
6. Rate of rate base return on $1,000	8%	

To summarize, in Example I, taxes were $80 and the rate of return was 8 percent.

In Example II, taxes are $60 because depreciation was accelerated, but the rate of return remains at 8 percent because the tax deferral of $20 is listed as a cost in the normalization reserve.

In Example III, accelerated depreciation again reduces taxes by $20 but the rate of return is deemed to be 10 percent because the tax deferral is not flowed-through.

In Example IV, accelerated depreciation is used with flow-through. Revenue requirements are adjusted to bring the rate of return down to 8 percent, which reduces taxes by an additional $20 for a total of $40.

Thus, in Example IV tax payments are only one-half of those in Example I, where straight-line depreciation is used for both book and tax purposes.[69]

His example IV makes the same incorrect assumption as his statement by reducing the tax a double amount. Example III, although denominated "flow-through," is really not, because the ratepayers are charged the same amount. To calculate flow-through, a commission in this example would reduce "earnings" by the $20 tax savings, thus keeping the rate of return of eight percent instead of ten percent. Gross revenue would be adjusted down to reflect this $20 and only this amount. Example II, denoted normalization, includes a deferred tax of $20 that is charged to the ratepayer, illustrating that under normalization the real rate of return is ten percent before the crossover point and six percent afterwards, a distortion that penalizes ratepayers in the earlier period. Similarly, if a commission did use the method of example IV, revenue would have to rise to $300 after the crossover point in order to maintain the eight percent return. This distortion provides one of the reasons that commissions should not

69. Nathan, *supra* note 66, at 3695-96.

compute flow-through as Mr. Nathan testified.

A second deficiency in Mr. Nathan's figures is that they only cover one year and do not take into account the loss in tax dollars from the reduction in rate base created by the deduction of deferred taxes and subsequent lower depreciation expenses. Over the long run, taking the rate base adjustment into account will usually result not in a loss of revenue, but in a net gain of tax dollars under flow-through.[70]

There is a possible circularity in the ratemaking formula which contributes to the confusion. In setting out the basic ratemaking equation as $R = (r \times B) + E$, taxes are included as an operating expense under "E", which is consistent with ratemaking procedures. If we ignore other expenses, as we can for purposes of this discussion, the formula to compute the required revenue is simply $R = (r \times B) + T$; "R" is the revenue allowed, "r" is the rate of return, "B" is the rate base, and "T" is the federal income taxes. To compute the taxes, however, the formula is $T = t \times R$; "t" is the tax rate. Obviously, "R" and "T" are interdependent variables. To illustrate, assume that $r \times B = \$100$, $t = 50\%$, $r = 10\%$, and $B = \$1{,}000$. The gross revenue requested is \$100 ($r \times B$) plus \$50 (taxes computed as $t \times R$). But if R is \$150, then a tax rate of fifty percent results in a \$75 tax; therefore, R becomes \$175, and at the next stage T becomes \$87.50, with the process repeating itself indefinitely.

Because rates are always set prospectively, the contention that when a company is earning at or over the maximum allowed in the rate proceeding the extra dollars will be taxable at the maximum rate is correct. This is true regardless of whether the company is allowed to take any accelerated depreciation, and it is stretching the truth to say that the Treasury loses an extra amount because of the flow-through of tax benefits used previously in computing the "allowable" rate of return. If, for example, the tax code declared a tax benefit equal to a reduction of fifty percent, the tax in the previous example would be \$25 not \$50. If flowed through, the revenue requirement would be reduced

70. Pollock, *The Effect of Alternative Regulatory Treatment of Tax Depreciation on Utility Tax Payments*, 26 NAT. TAX J. 43 (1973).

However critical I may be of Mr. Nathan's testimony, I am forced to admit that he earned his pay. The Bell System, which switched over to accelerated depreciation after the enactment of I.R.C. § 167(*l*), presently gathers in over \$2.5 billion in deferred taxes annually. *President's 1978 Tax Reduction and Reform Proposals, Hearings Before Ways and Means Comm.*, 95th Cong., 2d Sess., 2034 (1978) (statement of R. Batinovich).

to $25 and the tax at the second stage of the circle would be fifty percent of $125, or $62.50. If normalized, the tax would be fifty percent of $150, or $75. The difference is $12.50 or exactly fifty percent, which is equivalent to the fifty percent tax rate on the extra $25 tax benefit. The apparent double loss arises only by comparing the $62.50 tax on the flow-through basis to the $87.50 tax on the normalization basis, including the extra $25 of income created by the circularity; however, this is money that the Treasury would be able to tax only because of the circularity in the first place. The extra loss does not arise from flow-through, but from the circular structure that would arise if the commission proceeded by setting a gross revenue requirement rather than a net revenue requirement. The extra $12.50 amounts to taxes on income raised only for the purpose of paying taxes. It is hard to call this a real loss of money to the Treasury. Even if commissions were required to set rates in this way, the extra tax money would not result from the normalization, but from the increase in total revenue necessary to pay the tax in the second stage of the circularity. Requiring regulated industries to raise additional revenues solely to produce more tax money seems to be putting the cart before the horse and perverting the purpose of the tax laws, which is to base taxes on income rather than basing income on taxes.

To a certain extent this circularity exists if the company earns more revenue than it was allowed, because the additional money is taxed at the fifty percent rate. The taxable dollars that result from normalization may help out the Treasury if the company does overearn, but it really has nothing to do with these extra earnings, except that the normalization process creates some taxable dollars which the commission must double in setting rates. These double dollars might make up the lack of double dollars resulting from overearning, but the so-called loss arises from the overearning and not from the lack of normalization. Interestingly, the House Report went no further than to state that there is a double loss of revenue if a company is already earning the maximum allowed by its regulatory commission.[71] In inflationary times, of course, the companies are hard pressed to earn even the maximum allowed.

Congress also appears to have been motivated by a desire to freeze existing practices and to prevent any further shift toward accelerated depreciation, while at the same time precluding com-

71. H. REP. No. 413, *supra* note 63, at 132.

missions from imputing accelerated depreciation with flow-through to companies that did not elect this option.[72] The statute that was adopted, however, allows either straight-line or accelerated depreciation with normalization, but severely limits flow-through. Section 167(*l*) makes it impossible for a utility to benefit from accelerated depreciation for taxes if it flows through the benefits to the ratepayers, except with regard to property acquired prior to 1970 on which accelerated depreciation with flow-through was used[73] or property acquired after 1969 that is of the same or similar kind to that on which the company had been using flow-through prior to 1970.[74] Moreover, the section specifically allows a company to elect not to use flow-through on property acquired after 1969, even if it is of the same or similar kind on which flow-through was previously used, if the new property increases the company's operating capacity rather than replaces existing facilities.[75] Thus the Code made it possible for the company to override a regulatory order by its election, which would cut off the flow-through option on expansion property. If the regulatory commission refuses to approve normalization, the only other option is straight-line depreciation. By limiting required flow-through to those cases in which flow-through had actually been in use, Congress precluded the commissions from attributing flow-through to companies that chose normalization.[76]

Although the specific provision covering post-1969 expansion property could arguably be read as implying no option to elect normalization for pre-1970 property and post-1969 replacement property similar to that on which benefits were previously flowed through, the Federal Power Commission, in another turnabout, allowed a company to switch from flow-through to normalization on such property also.[77] The court of

72. H. REP. No. 413, *supra* note 63, S. REP. No. 552, *supra* note 63, at 172.

73. I.R.C. § 167(*l*)(1) (B). This law also allowed the companies to elect to switch to flow-through on pre-1970 property if it filed a timely election prior to Aug. 1, 1969. § 167(*l*)(4)(B). With respect to imputed flow-through, ironically the Supreme Court of California continued to impute flow-through to at least one company on the basis that a company's failure to elect that option when it was available constituted imprudent management. City of San Francisco v. Public Util. Comm'n, 6 Cal. 3d 119, 125-26, 490 P.2d 798, 801, 98 Cal. Rptr. 286, 291-92 (1971). The California P.U.C. has since given in to normalization while reducing the windfall earnings in another manner. See note 88 *infra*.

74. I.R.C. § 167(*l*)(2)(C).

75. I.R.C. § 167(*l*)(4)(A).

76. But see note 73 *supra*, concerning companies which failed to exercise the option for flow-through when it was available.

77. Texas Gas Transmission Corp., 84 PUB. U. REP. 3d (PUR) 193, 196-97 (F.P.C.

appeals reversed,[78] but the Supreme Court upheld the commission's interpretation.[79] Under section 167(*l*) it is now possible for a utility to switch from flow-through to normalization, but not from normalization to flow-through, without altogether losing accelerated depreciation tax benefits, except possibly when flow-through was used prior to 1969.

The FPC was obliged to give more consideration to section 167(*l*) than state regulatory commissions, because the 1969 amendment arguably overrules any older federal regulatory statute that might have been interpreted to require flow-through. Since Congress does not generally regulate or set intrastate rates, state regulators may not be bound by the terms of this statute in setting rates. The language does apply to state ratemaking, however, and the tendency has been for the state commissions to allow normalization on the theory that the current ratepayers will pay the same if straight-line depreciation is used for tax purposes and the companies might as well get the benefit.[80] In doing this, the commissions have now generally excluded the deferred tax reserve from the rate base or precluded it from earning any return.[81]

1970). The FPC later required flow-through on such properties, although not required to do so. *See* Pennsylvania Elec. Co., 10 PUB. U. REP. 3d (PUR) 351, 353 (1975). Still later, however, the FPC by rule adopted normalization of these and other benefits. *See* Order 530 discussed in Part III.

78. Memphis Light, Gas & Water Div. v. Federal Power Comm'n, 462 F.2d 853 (D.C. Cir. 1972), *revs'g* Texas Gas Transmission Corp., 84 PUB. U. REP. 3d (PUR) 193 (1970).

79. Federal Power Comm'n v. Memphis Light, Gas & Water Co., 411 U.S. 458 (1973), *revs'g* Memphis Light, Gas & Water Div. v. Federal Power Comm'n, 462 F.2d 853 (D.C. Cir. 1972).

80. At the beginning of 1965, normalization of accelerated depreciation benefits had been adopted for ratemaking in 23 jurisdictions and flow-through in 16. *What Others Think*, 75 PUB. UTIL. FORT. 62, 64 (Jan. 21, 1965). By 1970 the score was 22 normalization to 18 flow-through. *What Others Think*, 85 PUB. UTIL. FORT. 48, 49 (March 12, 1970). At present almost all jurisdictions have allowed normalization on post 1969 property. Annual Report on Utility and Carrier Regulation of the National Association of Regulatory Utility Commissioners 505 (1976) [hereinafter cited as NARUC Report]. The 1969 Amendment has caused the regulators to switch to normalization where required. 90 PUB. UTIL. FORT. 50 (Sept. 13, 1972). See cases cited note 157 *infra*. However, many jurisdictions have not altered their practice of requiring flow-through on pre-1970 property or post-1969 non-expansion property of a type on which flow-through was previously required. *See* note 161 *infra*. According to an Arthur Andersen & Co. survey for the Federal Energy Administration there were still eight such jurisdictions flowing through accelerated depreciation benefits as of early 1977. Study of the Treatment of Construction Work in Progress and Tax-Timing Differences: For Ratemaking Purpose in the Electric Utility Industry, Arthur Andersen & Co., 46 (1977) [hereinafter cited as Andersen Co. study].

The NARUC report showed only four such jurisdictions as of 1976. NARUC Report 505 (note that the Virgin Islands are not included in the Andersen Co. study).

81. The FPC in some cases had allowed a 1.5% return on the amount in the reserve.

To the extent that a tax benefit is denied on the basis of state ratemaking determinations, section 167(*l*) arguably imposes an unconstitutional condition on the exercise of state regulatory authority.[82] Utilities are unlikely to challenge this legislation. State regulatory commissions or consumer intervenors in rate cases who are in a position to challenge the law might appear to be asking the agency or court to see that Congress is required to allow accelerated depreciation to utilities. Actually, however, they could demand only that if Congress allows accelerated depreciation to public utilities, it be allowed to those flowing through the benefit.

Several attempts have been made to avoid section 167(*l*). The Maine Public Utilities Commission held that normalization was achieved by simply allowing normalization on the company books of account while setting rates on a flow-through basis. The Supreme Judicial Court of Maine, however, held this to be an abuse of discretion because the conclusion that the Internal Revenue Code could be interpreted this way was itself arbitrary, and because it placed the company in danger of losing the tax benefits, also an arbitrary act.[83] The court was no doubt correct in these conclusions. While a ruling that it would be better to lose the tax benefit may have been within the commission's discretion, the benefit clearly could not be retained under this method if section 167(*l*) is valid.

The California Public Utilities Commission, after making strenuous efforts to get around section 167(*l*), seemed ready to give up in the face of strong Treasury Regulations,[84] but the Su-

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Note 53 *supra.* At the time it abandoned normalization it also ruled that no return should be allowed on the accumulated deferred tax reserves. Alabama-Tennessee Nat. Gas Co., 53 PUB. U. REP. 3d (PUR) 390 (F.P.C. 1969), *aff'd* 359 F.2d 318 (5th Cir.), *cert. denied*, 385 U.S. 249 (1966). In later cases, under normalization, the FPC has allowed no return at all. *E.g.*, Transwestern Pipeline Co., 90 PUB. U. REP. 3d (PUR) 50, 62 (F.P.C. 1971). *Accord*, Sierra Pacific Power Co., 10 PUB. U. REP. 4th (PUR) 461, 463 (Nev. P.S.C. 1975); New England Tel. & Tel. Co., 11 PUB. U. REP. 4th (PUR) 297, 300 (Mass. D.P.U. 1975); Nashville Gas Co., 11 PUB. U. REP. 4th (PUR) 442, 447 (Tenn. P.S.C. 1975). *Contra*, Kansas Power & Light Co., 72 PUB. U. REP. 3d (PUR) 450, 460 (Kan. St. Corp. Comm'n 1968) (allowing a return of 1.54% on part of capital represented by deferred tax reserve). *See also* Treas. Reg. § 1-167(*l*)-1h(6)(i) (1971), which recognizes the legitimacy of excluding the amount of the deferred tax reserve from the rate base.

82. See Part V. B. *infra.*

83. New England Tel. & Tel. Co. v. Public Utils. Comm'n, 390 A.2d 8, 24 (Me. 1978), *revs'g in part* New England Tel. & Tel. Co., F.C. #2213 and U. 3178 (Me. P.U.C., decided June 10, 1977). The commission reasoned that § 167(*l*) merely required the company, not the commission, to normalize. *Id.* at 53.

84. Among others, Treas. Reg. § 1-167(*l*)-1(h)(6)(i) (1971) defines "normalization"

preme Court of California forced it to reconsider all possible alternatives. The court suggested that section 167(*l*), at least as interpreted by the Treasury Department, might infringe on the power reserved to the states under the tenth amendment,[85] that an automatic adjustment clause reducing rate base to take account of the investment capital available as a result of the deferred tax might be permissible,[86] and that the rate of return itself might be adjusted downward to reflect the availability of such capital.[87]

The California Commission, reconstituted after the transition from Governor Reagan to Governor Brown, came up with an approach that skirted the issue by lowering revenue needs based on the use of an "average annual adjustment" to the deferred tax reserve. The commission used an average of the estimated addition to the tax reserve for each of the three succeeding years to make annual adjustments to the test year rate base and indirectly to the tax expense.[83] It allowed normalization in compliance with section 167(*l*), but reduced revenue by recognizing heavy anticipated increases in deferred taxes, which annually decrease the rate base, thereby decreasing the revenue requirement (as a multiple of the rate base) and the income tax payable on such decreased revenue.[89]

The Internal Revenue Service has issued an advisory letter ruling that the average annual adjustment method is not a proper normalization method and will result in the loss of eligibility for accelerated depreciation.[90] Treasury Regulations require that the

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so as to exclude any situation where an amount in excess of the deferred tax reserve is excluded from rate base.

85. City of Los Angeles v. Public Utils. Comm'n, 15 Cal. 3d 680, 690 n.20, 542 P.2d 1371, 1377 n.20, 125 Cal. Rptr. 779, 785 n.20 (1975).

86. 15 Cal. 3d at 704, 542 P.2d at 1387, 125 Cal. Rptr. at 795.

87. 15 Cal. 3d at 704 n.42, 542 P.2d at 1387 n.42, 125 Cal. Rptr. at 795 n.42.

88. Pacific Tel. & Tel. Co., No. 87838 (Cal. P.U.C. Sept. 13, 1977). The case consolidated a number of proceedings involving Pacific Tel. and Tel. Co. as well as General Tel. and Tel. It is complicated by the fact that the utilities involved had previously had reductions in cost of service due to "imputed" flow-through, raising the question whether, after § 167(*l*) the commission could continue to impute the tax benefits to the company because it exercised poor management judgment in failing to elect to take accelerated depreciation with flow-through rate treatment when it had had the opportunity to do so (before 1970). See County of San Francisco v. Public Utils. Comm'n, 6 Cal. 3d 119, 490 P.2d 798, 98 Cal. Rptr. 286 (1971) (holding commission erred in not considering this option). The formula used by the commission, however, avoids this problem for the future as it permits normalization of taxes for both post-1969 and pre-1970 property.

89. Pacific Tel. & Tel. Co., No. 87838, at 23 (Cal. P.U.C. Sept. 13, 1977).

90. Letter from Geoffrey J. Taylor, Chief, Engineering and Valuation Branch, IRS, to Robert Dalenberg, Vice-President & General Counsel, Pacific Tel. & Tel. Co., Index No. 0167.23-00, 17, June 8, 1978.

deferred tax reserve and deferred tax expense be estimated for the same year.[91] The California Commission ruled that this requirement had been met,[92] but the IRS apparently disagrees.[93] On the surface, the tax reserve and the tax expense are estimated for the same year, but they are arguably not estimated by the same method for each year. The IRS letter is not a model of clarity, but it does seem to identify as grounds for objection to the plan its use of the adjustment method to revise the deferred tax reserve while "all related factors were frozen at the estimated level."[94] This type of objection may be made from a ratemaking standpoint to any kind of an adjustment clause, but it is unusual for the IRS to question ratemaking in this manner. The question presented to a commission or to a reviewing court by an adjustment clause is whether it is justified because it accurately reflects identifiable and isolated changes relating to an abnormal situation or whether it is not justified because it passes on an increase or decrease improperly based on one factor alone without taking into account related variations in other parts of the structure.[95]

On such a standard the California adjustment clause is suspect because it adjusts for the increased tax reserve but not for the accompanying anticipated increased income due to increased normalized taxes. A simple tax adjustment clause that makes an annual adjustment solely on the basis of lower taxes would be more acceptable in ratemaking. Depending only on the amount of tax benefit granted by the government, such a clause would compare favorably to the fuel adjustment clause, which occasionally has been upheld.[96] Decisions on fuel use are ultimately con-

91. Treas. Reg. 1.167(*l*)-(1)(h)(6) (1971).

92. Pacific Tel. & Tel. Co., No. 87838, at 27 (Cal. P.U.C. Sept. 13, 1977).

93. Letter from Geoffrey Taylor, note 90 *supra* at 5, 14.

94. *Id.* at 14.

95. Utility companies have, of course, not opposed the use of adjustment clauses which tend to incorporate increases in expenses sooner than would be true under normal test year rate proceedings. The courts have sometimes upheld adjustment clauses pertaining to the cost of fuel. *See* City of Norfolk v. Virginia Electric & Power Co., 197 Va. 505, 90 S.E.2d 140 (1955); City of Chicago v. Illinois Commerce Comm'n, 13 Ill. 2d 607, 150 N.E.2d 776 (1958); United Gas Corp. v. Mississippi Pub. Serv. Comm'n, 240 Miss. 405, 127 So. 2d 404 (1961); City of Akron v. Public Util. Comm'n, 5 Ohio 2d 237, 215 N.E.2d 366 (1966); Public Serv. Co. of N.H. v. New Hampshire, 113 N.H. 497, 311 A.2d 513 (1973); Maestas v. New Mexico Pub. Serv. Comm'n, 85 N.M. 571, 514 P.2d 847 (1973); State *ex rel.* Utilities Comm'n v. Edmisten, 291 N.C. 327, 230 S.E.2d 651 (1976). *Contra*, State *ex rel.* Utility Consumers Council of Missouri v. Pub. Serv. Comm'n, No. 60848 (Mo. Sup. Ct. *en banc*, June 29, 1979).

The utility companies are now in the position of opposing such a clause because it passes on a decrease rather than an increase in collectible charges. They are fortunate to have the IRS doing the objecting for them. See note 90 *supra*.

96. *See* cases cited in note 95 *supra*. *But cf.* Pennsylvania Pub. Utils. Comm'n v.

nected to decisions on which plant to use, whether to purchase power rather than generate, and what type of plant to build. All these factors are more related to the total rate structure than the amount of taxes.

Moreover, use of such an annual tax adjustment clause would be bolstered by many commission rulings that the actual tax to be used for setting rates is not the test year tax figure, but a figure adjusted to take account of known changes or changes that can be predicted or estimated with reasonable certainty. Among these are increases or decreases in revenue that will result from a new rate order, changes in the tax code, adjustments to be made as a result of the filing of consolidated returns, and net operating losses available to carry forward.[97] The Supreme Court has held rates that ignore the most recent data in favor of prediction based on older data to be confiscatory.[98]

Although such a complete tax adjustment formula might pass ratemaking review, it would also directly challenge section 167(*l*). The formula actually adopted by the California Commission seems to comply with the language of the Code and the Treasury Regulations despite its theoretical weaknesses. The IRS may simply be taking the position that any ratemaking method that lowers allowed revenue requirements is unlawful if the IRS perceives it as depriving the company shareholders of the tax benefits. This approach gives the IRS broad powers and duties in setting rates for intrastate sales of electricity.[99] Congress may have intended to give the IRS this broad power to deny deductibility because of the indirect effects of the ratemaking process on total tax liability, but this conclusion is doubtful.

The California Supreme Court, although advised of the IRS ruling, has declined to review the matter any further.[100] Certiorari

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Philadelphia Elec. Co., 91 PUB. U. REP. 3d (PUR) 321, 361 (Pa. P.U.C. 1971) denying the company use of an estimated three year adjustment method for computing normalized taxes because it failed to take into account related benefits based on increased plant capacity.

97. See notes 142, 145 and 146, and accompanying text *infra.*

98. West Ohio Gas Co. v. Public Utils. Comm'n, 294 U.S. 79 (1935). The California utilities relied heavily on this case in arguing for use of test year data only, but the precedent can be taken the other way since the estimates in *Pacific Tel. & Tel.* are to be based on growth figures in the most recent years. Pacific Tel. & Tel. Co., No. 87838 at 36 (Cal. P.U.C. Sept. 13, 1977).

99. Pacific Tel. & Tel. Co., No. 87838 (Cal. P.U.C. Sept. 13, 1977) highlights Surrey's warning against the use of tax subsidies because they require the tax authorities to administer areas beyond their field of expertise. See note 26 *supra.*

100. Review Denied. Doc. Nos. 23746 and 23743 (Cal. S. Ct. July 13, 1978).

has been denied by the Supreme Court.[101] Judicial resolution of these issues is now problematic.[102] The clash between the IRS and the California Public Utilities Commission has resulted, so far, in the approval of questionable ratemaking by the court and commission on one side, and the undesirable injection of the IRS into state ratemaking decisions on the other. Congress would do well to look at proposals to replace the income tax on utilities with either a tax on gross receipts or on usage.[103]

C. *Tax Benefits Derived From Reduced Useful Life in Calculating Depreciation for Tax Purposes*

Before considering further the policies which support normalization, the discussion will turn briefly to a second form of depreciation-related tax benefit available under the Internal Revenue Code. Taxpayers, including utilities, are allowed to group different kinds of assets in large classes for depreciation purposes and to assign to these assets a much shorter tax life than that generally used for ratemaking depreciation.[104] For instance, a nuclear electric generating plant which for ratemaking purposes may be given a useful life of thirty years[105] has under IRS regulations an asset guideline period of twenty years, an upper limit of

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101. Petitions for cert. filed, Nos. 78-606 and 78-607 (U.S. Sup. Ct., Oct. 1978), 47 L.W. 3278.

102. The companies have filed suit to enjoin the enforcement of the commission order. Preliminary injunction was denied. Pacific Tel. & Tel. Co. v. California Pub. Utils. Comm'n, General Tel. & Tel. Co. v. California Pub. Utils. Comm'n, Nos. 79-1024 RMT and 79-1025 RMT (C.D. Cal., Mar. 30, 1979); Notice of Intent to Appeal filed, Nos. 79-3150 and 79-3151 (9th Cir. Mar. 30, 1979). The tax consequences may be reviewed in later proceedings in the tax court or by district court suit for refund of taxes after the benefit has been denied by the IRS. Since the utility companies have been pushing for normalization, such tax litigation would amount to a friendly suit.

103. *See* note 49 *supra*. The California Commission itself made this recommendation. Pacific Tel. & Tel. Co., No. 87838, 23 (Cal. P.U.C. Sept. 13, 1977).

104. I.R.C. § 167(m), adopting the "asset depreciation range," was enacted in 1971. In 1962 the Treasury had begun to allow the grouping of diverse assets according to the "guideline" system, which included the opportunity to shorten, based on a reserve ratio test, the depreciable life of assets within the class. Rev. Proc. 62-21, 1962-2 C.B. 418. The benefits were made available to electric and gas companies by Rev. Proc. 64-21, 1964-1 C.B. 685 and 1965-1 C.B. 759, easing the reserve ratio test so that utilities might benefit. The new "class life" system adopts many of the old guideline classes but abandons the reserve ratio test in favor of an asset depreciation range. The asset depreciation range allows a period 20% longer or shorter than the basic guideline period but requires an election to be made initially without the opportunity for later revision available under the older method.

105. Northern States Power Co., 11 PUB. U. REP. 4th (PUR) 385, 394 (Minn. P.S.C. 1975).

twenty-four years, and a lower limit of sixteen years.[106] This results in a tax depreciable life of approximately one-half the useful life allowed for regulatory purposes. Studies have shown the tax lives under these code provisions are nineteen to thirty-six percent too short, and thirty-five to forty-four percent too short with depreciable real property improvements.[107]

Although nothing in the Internal Revenue Code specifically requires normalization of these benefits,[108] the Treasury Regulations state that accelerated depreciation will be denied if a utility company uses a useful life less than the applicable asset guideline period.[109] The Treasury apparently believes that use of a longer period might unlawfully counterbalance the effects of normalization.

By not requiring the shortest life, but only the use of its median guideline period, the Treasury Department has taken an intermediate position on the ratemaking effects of the asset depreciation range itself, although, of course, even the median period is shorter than that usually allowed for ratemaking. That the Treasury Department believed itself required to take a position at all, however, illustrates the problem that once Congress interferes, even slightly, with state ratemaking procedures, the IRS and the courts may become involved with many other aspects of the process that might have indirect effects contrary to the congressionally mandated policy. Thus, if a commission lowers the rate of return, denies construction work in progress, or in any way, related or not related to taxes, lowers the revenue requirement, this arguably allows, indirectly but unlawfully, the flow-through of a tax benefit such as accelerated depreciation.

Since the Treasury Regulation requires normalization of only the benefits of the shorter period allowed by the asset guideline period itself and not the additional twenty percent, some discre-

106. *See* Treas. Reg. 1.167(a)-11 (1971). Rev. Proc. 74-50, 1974-2 C.B. 506.

107. Beidleman, *Economic Depreciation in a Capital Goods Industry,* 29 NAT. TAX J. 379, 386 (1976); Coen, *Investment Behavior, The Measurement of Depreciation and Tax Policy,* 65 AM. ECON. REV. 59, 69-70 (1975); Taubman and Rasche, *Economic and Tax Depreciation of Office Buildings,* 22 NAT. TAX J. 334, 342 (1969). For a summary of these studies see Lischer, *Depreciation Policy, Whither Thou Goest,* 32 S.W.L.J. 545, 592-93 & nn.319-25. Lischer recommends the repeal of asset depreciation range along with repeal of accelerated depreciation for real property improvements. *Id.* at 593, 602-03. Several bills have been introduced in Congress to repeal asset depreciation range. *Id.* at 602-03 & n.386.

108. I.R.C. § 167(*l*) addresses only the method of depreciation in terms of the more rapid methods allowable under § 167(b)(2)-(4).

109. Treas. Reg. § 1.167(a)-11(b)(6). The company is not required to use the shortest life, but is forbidden to use a period longer than the IRS standard guideline period.

tion still remains in the regulatory commissions. On the whole, the commissions seem slightly more resistant to normalization in this area. The 1976 National Association of Regulatory Utility Commissioners (NARUC) report shows six states using the actual tax rule for rates with respect to guideline depreciation and seven using the actual tax rule for asset depreciation range.[110] The same report, however, shows that twenty-seven states either require or permit normalization of guideline depreciation benefits and twenty-nine either require or permit normalization of asset depreciation range benefits.[111] The Federal Power Commission required normalization of these tax benefits as part of General Order 530.[112] The statistics cited are not too helpful, as there is some question on the degree of normalization allowed or required, and the Treasury Regulations have not received much discussion. Nevertheless, a significant number of jurisdictions have now either required or allowed normalization of these benefits, despite an earlier tendency to require flow-through[113] or even to impute flow-through of these benefits to companies which had not used them.[114] At least one state has acknowledged the Treasury Regulations as the primary reason for allowing normalization of these benefits.[115]

Without trying to exhaust every possible tax benefit, one other form of accelerated depreciation should be noted; IRC section 169 allows for a five-year amortization of nonprofit certified pollution control facilities in lieu of regular depreciation. The Treasury Regulations do not require normalization of these benefits.

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110. NARUC Report, *supra* note 80.

111. *Id.* A number of states are listed as undecided.

112. See note 167 and accompanying text *infra.*

113. *E.g.,* Consideration of the Normalization Method of Accounting for Certain Tax Deferrals, Doc. No. 11641 (Conn. P.U.C., Oct. 14, 1975); Pennsylvania Pub. Utils. Comm'n v. Metropolitan Edison Co., 96 PUB. U. REP. 3d (PUR) 113, 137-38 (Pa. P.U.C. 1972); Washington Utils. & Transp. Comm'n v. Pacific Power & Light Co., 7 PUB. U. REP. 3d (PUR) 470, 487 (Wash. Util. & Transp. Comm'n 1974).

114. Consolidated Ed. Co. of N.Y., Inc., 85 PUB. U. REP. 3d (PUR) 276, 292 (N.Y.P.S.C. 1970); United Fuel Gas Co., 46 PUB. U. REP. 3d (PUR) 118, 129 (W. Va. P.S.C. 1962). *But see* Consolidated Ed. of N.Y., Inc., 98 PUB. U. REP. 3d (PUR) 455, 466 (N.Y.P.S.C. 1973), which allowed normalization of the asset depreciation range benefits in consideration of "the overall viability of the company" after publication of the final Treasury Regulations.

115. Michigan Bell Tel. Co., 3 PUB. U. REP. 4th (PUR) 1, 14-15 (Mich. P.S.C. 1973) (ordering normalization despite the Mich. Attorney General's argument that not even the IRS could force it on the commission).

D. *Regulatory Policy Relating to Normalization of Tax Depreciation Benefits*

Although section 167(*l*) has furnished the main impetus for acceptance of normalization, normalization was sometimes allowed even before the 1969 amendment. A number of arguments have been raised. The most common argument is that Congress, by increasing the depreciation deduction in early years, merely deferred the tax on current income; thus, current ratepayers should pay the amount of the tax which the company then puts into a deferred tax reserve account to be kept until a later time when the tax is actually collected.[116]

This argument provoked the counter argument that the taxes are not really deferred at all, but are rather saved, because as long as a company continues building new plants there will be new front-end accelerated depreciation to take the place of that used on the older plant moving into the bottom end of the accelerated depreciation cycle. In *Alabama-Tennessee Natural Gas Co.*, the FPC simply reversed its position when confronted with factual evidence that the "turning point" did not seem to be in sight.[117] More elaborate mathematical models demonstrate that so long as a utility company continues to grow or remains stable in its total yearly sales, and replaces old plants on a cyclical basis, the amount of tax deferral will not decrease.[118]

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116. This theory was set forth by the FPC in the leading case approving normalization, Amere Gas Utils., 15 PUB. U. REP. 3d (PUR) 339 (F.P.C. 1956), approving normalization accounting on the basis of Congressional intent to create a deferral rather than a reduction, although relying also on previous allowance of normalization of accelerated amortization under former I.R.C. § 169, repealed "'76 Tax Reform Act," Pub. L. No. 94-455, tit. XIX § 1951(b)(4)(A), 90 Stat. 1837 (1976). See also Panhandle E. Pipe Line Co., 3 PUB. U. REP. 3d (PUR) 396 (F.P.C. 1954) *rev'd on other grounds*, but on this point *aff'd sub nom.* Detroit v. Federal Power Comm'n, 230 F.2d 810, 821-22 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829 (1956); El Paso Nat. Gas Co., 22 F.P.C. 260, 267 (1959), *aff'd* 281 F.2d 567 (5th Cir. 1960) (allowing normalization for ratemaking purposes on same grounds).

117. Alabama-Tennessee Nat. Gas Co., 31 F.P.C. 208, 215-17 (F.P.C. 1964), *aff'd sub nom.* Alabama-Tennessee Nat. Gas Co. v. Federal Power Comm'n, 359 F.2d 318 (5th Cir. 1966), *cert. denied*, 385 U.S. 847 (holding normalization "premature" until such time as a company proved that higher tax payments would result in the reasonably foreseeable future). The *Alabama-Tennessee* decision was criticized even before the enactment of § 167(*l*) as being contrary to the congressional policy of stimulating production by making funds available to producers. Note, *Liberalized Depreciation: About Face by the FPC*, 50 VA. L. REV. 298, 335 (1964).

118. INSTITUTE OF PROFESSIONAL ACCOUNTING, UNIV. OF CHICAGO, ACCELERATED DEPRECIATION AND DEFERRED TAXES: AN EMPIRICAL STUDY OF FLUCTUATING ASSET EXPENDITURES, EMPIRICAL RESEARCH IN ACCOUNTING: SELECTED STUDIES 93 (1967); see Livingstone, *Accelerated Depreciation, Cyclical Asset Expenditures and Deferred Taxes*, 5 J. OF ACCOUNTING RESEARCH, 77, 77-78 (1967); Livingstone, *Accelerated Depreciation, Tax Alloca-*

This argument for flow-through treatment is strengthened by the observation that if a utility company should not continue to grow or to at least remain stable in size, present conditions of heavy plant investment and high interest long-term debt make it very likely that the company would have no future taxable income against which to use up the deferred tax reserve. Since utilities are regulated, however, the regulatory authorities would have a duty to set rates providing an opportunity to earn profit even in lean years.

The argument that current "deferred" tax benefits are a permanent savings may well hold true for deferrals made continuously over a stable period of moderate growth and replacement of plant. The argument might not hold true indefinitely, however, during a long period of great plant growth such as we are presently experiencing if that growth tapers down in later years. After a certain point of growth is reached, any future accelerated depreciation attached to new equipment might well be depleted in maintaining the level of deferred tax reserve accumulated in the early years and would not be available for maintaining benefits generated during the later part of the building period. Calculating when this point will be reached presents a formidable task.

The Federal Power Commission made "findings" that the tax benefits were a "deferral" or a "true tax savings" according to whatever result it reached at a particular time.[119] This debate turned the question into a factual issue[120] concerning whether the deferred taxes would ever become real taxes, thus drawing attention away from the underlying question of ratemaking policy. Even if the taxes are considered deferred rather than saved, however, the period of deferral is going to be so long that the distinction may not be particularly relevant to ratemaking.

Assuming *arguendo* that the taxes are deferred, a basic question arises concerning whether it is proper ratemaking to charge deferred taxes to the current ratepayers or to the ratepayers in later years after the "crossover point" is reached. Although such questions can be easily, if not properly, ignored if the time differential is short on the assumption that the main body of ratepayers does not change much from year to year and it is simply a ques-

tion and Cyclical Asset Expenditures of Large Manufacturing Companies, 7 J. OF ACCOUNTING RESEARCH 245 (1969).

119. *See* notes 116 and 117 *supra*.

120. Amere Gas Util. Co., 15 PUB. U. REP. 3d (PUR) 339, 340 (F.P.C. 1956) (summary of expert testimony on the question).

tion of when the ratepayer will pay the tax,[121] when it became apparent that billions of dollars were going into reserves for an indefinite period to pay the taxes which might come due twenty or thirty years later, if ever, the question whether the ratepayers of today or tomorrow should properly be charged took on added significance for many commissions. Regulatory agencies have justified flow-through on the theory that it is unfair to charge today's ratepayers for tomorrow's costs.[122] Others have attempted to justify normalization on the theory that it is unfair to charge tomorrow's ratepayers for today's costs.[123] At least one agency has said it is unfair either way.[124]

In considering this question, the ratemaking problem has become interwoven with the accounting question. Normalization, however, can not be justified under accounting theory nor under sound ratemaking principles. The accounting community is itself somewhat divided on the treatment of tax benefits. In general, accountants believe that to accurately report income, costs must be matched with revenues. Revenue is ordinarily measured over a period of time. Expenses or losses are related to the revenues in the period the revenue is recognized if the expense can be directly associated with a particular item of revenue, as for example with the production costs of an item sold. If an expense cannot be associated directly with a specific revenue item, it is generally charged to the period in which it was incurred.[125]

Income taxes are not usually associated with specific revenue items. Such taxes are simply mandatory contributions to the cost of government.[126] Some accountants even view income taxes as a distribution of income, rather than an expense; however, income

121. By this reasoning, the main financial consideration is simply who is to pay for the use of the money during the time between collection by the utility and payment to the government.

122. Lea City Gas Co., 10 PUB. U. REP. 3d (PUR) 279, 289 (N. Mex. P.S.C. 1955).

123. Arizona Pub. Serv. Co., 20 PUB. U. REP. 4th (PUR) 253, 259 (Ariz. Corp. Comm'n 1977).

124. Maine Pub. Serv. Co., 12 PUB. U. REP. 3d (PUR) 349, 351 (Me. P.S.C. 1956). See also E. BRIGHAM & J. PAPPAS, note 47 *supra*, at 215, demonstrating that the effect of normalization on total rates is dependent on the length of the depreciation period and the growth rate during this time. Only in a situation of no growth or of decreasing growth does flow-through result in higher rates in later years, which will significantly offset lower rates in earlier years. *Id.* at 87.

125. G. THOMPSON, *supra* note 35; S. DAVIDSON, J. SCHINDLER & R. WEIL, FUNDAMENTALS OF ACCOUNTING 188-90 (5th ed. 1975).

126. W. MEIGS, C. JOHNSON, T. KELLER & A. MOSICH, INTERMEDIATE ACCOUNTING 91 (2d ed. 1968).

taxes are usually reported as expenses primarily because financial reporting itself is directed to the existing or potential stockholder, to whom corporate income taxes are at least indirectly an expense.[127]

The accounting profession, after much debate and study,[128] adopted a position in favor of normalization.[129] This position applies to financial reporting of a variety of transactions in which income tax recognition occurs in a different period than normal financial recognition.[130] The Accounting Principles Board (APB) recommends the "deferred" method, under which effects of tax transactions that reduce or increase current taxes are deferred until later periods when accounting recognition of a related transaction occurs.[131]

Since a nonregulated business may receive a considerable boost in earnings from the use of accelerated depreciation for tax purposes, there can be little quarrel with the principle that persons reading the financial statement should be warned that future tax liability may be higher to balance the present tax benefit. Although a footnote to the financial statement might be considered sufficient,[132] it has been deemed appropriate to go further and show the deferred tax as a current expense. In theory, this better informs an investor who wishes to easily compare statements of a company that has not currently added plant and equipment and has no tax benefit with one which has.[133] The

127. S. DAVIDSON, J. SCHINDLER & R. WEIL, note 125 *supra* at 192-93.

128. H. Black, *Interperiod Allocating of Corporate Income Taxes, Accounting Research Study No. 9*, AM. INST. OF CERT. PUB. ACCTS., 12-61 (1966). This study sets forth and evaluates several different methods of handling accounting items where the tax recognition of an item does not occur in the same period as the period recognized for accounting purposes.

129. Opinions of the Accounting Principles Board, 11 AM. INST. OF CERT. ACCTS. (1967). APB opinions carry considerable weight within the profession, and any material departure therefrom in financial statements or auditors' reports is required to be disclosed.

130. *Id.* at 157.

131. *Id.* at 158, 162-63.

132. S. DAVIDSON, J. SCHINDLER & R. WEIL, note 125 *supra* at 476, points out that a deferred tax fails three of the four tests normally suggested for defining a liability (contractual obligation, certainty of amount, and certainty of date due), and therefore recommends including deferred taxes in the indeterminate taxes liability section of a balance sheet since deferred taxes are not a liability.

133. Price Waterhouse & Co., in proposing a more flexible modification of Op. No. 11, suggests that although failure to account for deferred taxes might mislead a prospective buyer into thinking a security is worth more than it is, a seller might be induced to sell too cheaply on the basis of inclusion of deferred taxes. This misvaluation could occur in situations in which the actual payment of the tax may never come about. PRICE WATER-

earnings of a public utility are not based on competition, but rather on rates which include allowances for operating expenses and taxes. The possibility of higher future taxes for a utility company is not tremendously significant because the commission that sets rates will provide sufficient income to cover the tax expense.

Traditionally, different accounting methods have been used for setting utility rates than are used for financial reporting generally. Opinion No. 11 of the APB recognized that for ratemaking purposes normalization may not apply, and that if flow-through is used for ratemaking, the use of normalization in reporting the income of the company might be more confusing than to simply report on the same basis used for setting rates.[134]

This brief examination of the accounting treatment again highlights the problem of including regulated utilities under section 167 at all. The increased deduction applies only if the taxpayer company acquires new plant and equipment. Every company that makes such acquisitions receives the benefits. Nonregulated companies simply get some extra dollars with which they can do whatever they like. They might use this cash to pay dividends, to create a cash reserve, or perhaps to pass the benefits on to the consumers in lower prices. The latter choice is unlikely unless the company sees a chance to increase long range profits. In any event, the choice is made according to market conditions. If the company is in a fiercely competitive sales situation it will lower prices. This is analogous to flowing through the benefits. Another company may raise its dividends and issue some new securities, while a third might simply pay out the tax savings as cash for a new plant, thus increasing the value of its capital for the benefit of its stockholders. The point is that a nonregulated firm does not make a choice between flow-through or normalization because its prices are determined by market competition.

In theory, the supervision of utility companies by regulatory commissions substitutes regulation for competition.[135] To the ex-

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HOUSE & CO., IS GENERALLY ACCEPTED ACCOUNTING FOR INCOME TAXES POSSIBLY MISLEADING INVESTORS (July 1967).

134. Op. No. 11, note 129 *supra* at 156. Further Committee on Accounting Procedure of AICPA, pts. 8-9 ACCOUNTING RESEARCH BULLETIN 44 (July 1958) provides that a company on flow-through rates need not report on the basis of normalization, but requires disclosure of flow-through status. The Financial Accounting Standards Board appointed a new task force in 1978 to investigate areas in which utility accounting differs from that employed in other industries. *Business Week*, April 3, 1978 at 88.

135. J. BONBRIGHT, *supra* note 33 at 93.

tent that there is an analogy to nonregulated firms, a commission might sense that it should treat the utility as though it were in a highly competitive situation and require flow-through in the form of lower prices. Most commissions did this initially, and the result was logical because the commissioners reasoned that under the law they were obligated to provide a fair rate of return to each company aside from normalization.

The concept of a "deferred tax" makes it easier for a regulatory commission to justify normalization, because it makes an "expense" out of what is not an expense. The term "deferred tax," however, is a misnomer even in accounting terms. In normal accounting parlance, a deferred item of income or expense is an item incurred currently that properly relates to a later year. A deferred expense is normally an item paid currently, but relating to future income producing transactions. For instance, a company pays an insurance premium for coverage over three years. Two-thirds of the expense is deferred in the first year. Similarly, if a company makes a tax payment in 1978 for 1979 taxes, a deferred expense is created. Although the current revenue collected to pay the future taxes may be called deferred revenue,[136] the name at best identifies the result of normalization; it does not justify the practice.

A tax benefit is neither income nor expense.[137] With accelerated depreciation, the tax expense does not occur currently, simply because Congress has said that the tax expense is to be deferred. The current recognition of this possible future expense is, if anything, an accrued expense. Ordinarily, however, an expense is accrued when there is an actual expense related to the current period but not charged until later. Accrued taxes are commonplace. A calendar year taxpayer on the accrual basis is taxed in April of 1978 for income earned in 1977; this actual tax relates to 1977 operations and is therefore a tax accrued on 1977 income. With normalization the tax is not accrued at all, but is postponed or forgiven until another year altogether. The "deferred tax" is therefore not a tax at all, but merely a reference to possible future taxes. The APB and those jurisdictions that have approved normalization have confused deferral of the tax with deferral of the payment of the tax. If Congress had imposed the tax on current

136. *See* E. SPILLER, FINANCIAL ACCOUNTING 89 (rev. ed. 1971).

137. Op. No. 11 recognized that the deferred tax is not an expense but a "deferred credit." Opinions of the APB, *supra* note 129, at 163.

income but allowed the companies to pay it in a later year, a much stronger accounting argument for a deferred tax would exist. But Congress has actually postponed the tax itself.

Furthermore, the notion of charging this possible future tax to current ratepayers ignores the nature of taxes, which are charged to the public for the currently payable costs of government, including, of course, carrying costs of government debts. The taxpayer does not have any choice but to pay them as a cost of the continuing right to remain in business.[138] In general, a utility acts as a conduit for taxes, passing the tax of the government on to the ratepayer.[139] With respect to local taxes, the utility should not charge them as a general expense to all ratepayers, but should pass them on directly to the ratepayers within the jurisdictions collecting the tax.[140]

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138. This description of the use of the taxing power as applied to utilities may be more correct in theory than in practice. J. BONBRIGHT, *supra* note 33, at 403-04, relying on H. Simpson, *Taxation of Public Service Companies,* published in *Materials for the Study of Public Utility Economics* 471-90 (H. Dorau ed. 1930) and H. GROVES, FINANCING GOVERNMENT (5th ed. 1958) traces utility company taxation through an initial period of subsidization or favored treatment lasting to the middle or end of the nineteenth century, followed by a short period of neutrality, ending with the great depression, and then followed by a period of overtaxation, perhaps engendered by public perception of excess profits arising out of "fair value" rate base and avoidance of regulation through holding companies, and continued simply as a means to support burgeoning government expenditures.

Viewed in this historical perspective, the current tax benefits granted utilities may help to cut down an excessive tax burden. In fact, they have swung the pendulum back the other way. *See* note 16 *supra*. However, normalization converts the defunct tax burden into a rate burden.

139. FARRIS AND SAMPSON, PUBLIC UTILITIES: REGULATION, MANAGEMENT AND OWNERSHIP, 106-07 (1973). *See* notes 142-45 *infra* for cases holding to the "actual tax" rule.

140. City of El Dorado v. Arkansas Pub. Serv. Comm'n, 235 Ark. 812, 362 S.W.2d 680 (1963) (order roughly passing on municipal taxes on gas meters to customers within each municipality, eliminated previous discrimination where customers in low or no tax municipalities were forced to help pay tax in high tax municipalities); Florida Pub. Util. Co., 11 PUB. U. REP. 4th (PUR) 437, 439 (Fla. P.S.C. 1975) (burden of local franchise fees should be borne by those customers who benefit primarily from the city services funded by the fees); Village of Maywood v. Illinois Comm. Comm'n, 23 Ill. 2d 447, 178 N.E.2d 345 (1961) (rates which do not impose burden of franchise tax on users in community which collects the tax are discriminatory); City of Elmhurst v. Western United Gas and Elec. Co., 363 Ill. 144, 1 N.E.2d 489 (1936); Consumers Power Co., 14 PUB. U. REP. NS (PUR) 36, 41 (Mich. P.U.C. 1936) (charging local taxes as a general operating expense is an unjust burden on customers outside the municipality); City of West Plains v. Missouri Pub. Serv. Comm'n, 310 S.W.2d 925 (Mo. 1958); City of Newport News v. Chesapeake and Potomac Tel. Co., 198 Va. 645, 96 S.E.2d 145 (1957); Montana-Dakota Util. Co., 15 PUB. U. REP. 3d (PUR) 246 (Wy. P.S.C. 1956) (treatment of local excise taxes as a general expense to be paid *pro rata* by all customers is discriminatory). *Accord,* Treatment of Franchise Fees for Ratemaking Purposes, 12 PUB. U. REP. 4th (PUR) 289 (Fla. P.S.C. 1975)

This illustrates the general rule that taxes are simply passed on to the ratepayers directly.[141] Commissions have differed on whether the amount of taxes allowed in a rate proceeding should be the amount computed by applying the legal tax rates in effect or to be in effect during the period to projected taxable income,[142] or whether the amount of taxes allowed should be limited to actual taxes paid in a test year.[143] The principle that the taxes should reflect the actual amount of tax costs seems to underlie both methods, and the regulatory agencies seldom departed from this principle prior to normalization.[144] This rule of "actual taxes"

(approving similar treatment of local franchise fees even though they were not held to be "taxes").

141. Galveston Elec. Co. v. City of Galveston, 258 U.S. 388, 399 (1922); Federal Power Comm'n v. United Gas Pipe Line Co., 386 U.S. 237, 240, 243 (1967) (approving calculation of federal income tax at actual effective cost, even though this involved some use of loss generated by nonregulated companies in lowering tax rate of regulated company, where a consolidated return was filed and the nonregulated companies could not use up all the tax losses). Section 409A of the Uniform System of Accounts, used by most regulatory commissions, provides: "This account shall include the amount of state and federal taxes on income properly accruable during the period covered by the income statement to meet the actual liability for such taxes . . . ." 18 C.F.R., Pt. 101 § 409 (1977).

142. Bridgeport Hydraulic Co., 90 PUB. U. REP. 3d (PUR) 111, 120-21 (Conn. P.U.C. 1971) (company cannot recover higher tax expense that would have been charged had a separate return been filed, but is limited to allocated portion of tax on a consolidated basis); General Tel. Co. of Fla., 76 PUB. U. REP. 3d (PUR) 380 (Fla. P.S.C. 1968) (*pro forma* adjustments made to company's book taxes); Northwestern Bell Tel. Co., 2 PUB. U. REP. 4th (PUR) 312 (Neb. P.S.C. 1974) (adjustment for known increases in state income tax occurring after test year); Rhode Island Consumer's Council v. Smith, 113 R.I. 384, 322 A.2d 17 (1974); Public Serv. Comm'n v. Utah Power & Light Co., 50 PUB. U. REP. 3d (PUR) (Utah P.S.C. 1943) (disallowing excess profits taxes not reported or paid); Chesapeake and Potomac Tel. Co. of W. Va., 18 PUB. U. REP. 3d (PUR) 236, 243 (W. Va. P.S.C. 1976). See also cases cited at note 268 *infra*.

143. Hawkeye State Tel. Co., 2 PUB. U. REP. 4th (PUR) 166, 177 (Iowa State Comm. Comm'n 1973) (interest deduction attributable to construction work in progress is included in computing allowable taxes); *e.g.*, Diamond State Tel. Co., 149 A.2d 324 (Del. Sup. Ct. 1959) (actual tax expense can't be adjusted downward by attributing higher debt and interest charges to subsidiary, where parent corporation had much higher debt rate); New England Tel. & Tel. Co., 13 PUB. U. REP. 4th (PUR) 65 (Me. P.U.C. 1970) (taxes should be on actual paid basis); General Tel. Co. v. Tennessee Pub. Serv. Comm'n, 7 PUB. U. REP. 3d (PUR) 273, 280-82 (Tenn. P.S.C. 1974) (property taxes should be calculated based on test year); Potomac Ed. Co. of W. Va., 13 PUB. U. REP. 4th (PUR) 391 (W. Va. P.S.C. 1976) (property tax deduction computed on basis of taxes actually paid during test year).

144. "An income tax allowable should not exceed the taxes actually paid or demonstrably required to be paid in the immediate future." 1 A. PRIEST, *supra* note 42 at 54, citing South Carolina Generating Co., 15 PUB. U. REP. 3d (PUR) 289, 303 (F.P.C. 1956). *But see* Northwestern Pub. Serv. Co., 22 PUB. U. REP. 4th (PUR) 60, 82-83 (S.D.P.U.C. 1977) (current construction related *ad valorem* taxes should be capitalized along with other construction costs rather than allowed as a current expense).

has been generally accepted,[145] and occasionally it is stated that any allowance for taxes exceeding the actual taxes payable results in undue profits.[146]

The rule charging to ratepayers the actual current taxes best comports with the theory of utility taxation. The ratepayer gets no benefit or service from the utility for the dollars that he pays to defray the utility's taxes. The only benefit that he receives is that the government collecting the tax allows the utility to stay in business and spends the taxes for what economists call social goods. The ratepayers who receive these benefits should be as nearly as possible the ratepayers who pay the taxes. Flow-through is the only method which achieves this goal. Under flow-through, the current ratepayers pay the current taxes. To the extent that taxes are or may be greater in later years from accelerated depreciation, the ratepayers in those later years who receive the benefits from those taxes are properly charged for them.

Normalization reverses this, and requires the current ratepayers to pay taxes for the benefit of the future ratepayers. Even assuming that the benefit is a tax deferral rather than a tax saving, normalization is not a proper way to collect the taxes. Aside from the question of the beneficial use of the money in the intervening years, normalization charges the wrong ratepayers with the tax.[147] Courts or commissions that have arrived at the opposite conclusion[148] have overlooked the nature and purpose of

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145. The leading case is Galveston Elec. Co. v. City of Galveston, 258 U.S. 388 (1922), where Justice Brandeis stated in calculating whether a return is proper "it is necessary to deduct from gross revenue the expenses and charges; and all taxes which would be payable if a fair return were earned are appropriate deductions." *Id.* at 399. *Accord*, Cincinnati Gas & Elec. Co. v. Public Utils. Comm'n, 173 Ohio St. 473, 184 N.E.2d 84 (1962) (denying normalization and limiting company to taxes "actually paid").

146. Hawkeye State Tel. Co., 2 PUB. U. REP. 4th (PUR) 166, 176 (Iowa Comm. Comm'n 1973) ("the ratepayer should be responsible only for the actual amount of taxes payable and any hypothetical tax liability should not be included in operating expenses. Obviously, a holding company is not entitled to extraneous profits resulting from charges to its subsidiaries for tax expenses in excess of the fair share of actual consolidated tax expenses. . ."); City of Pittsburgh v. Pennsylvania Pub. Utils. Comm'n, 182 Pa. Super. Ct. 551, 580, 128 A.2d 372, 385 (1956) (denying normalization and stating: "a utility is allowed to pass on to its customers only its proper expenses and allowances plus a legitimate profit or return to the utility. A bonus or gratuity based upon hypothetical considerations in addition to this is improper and not permissible.") (citations omitted); United Fuel Gas Co., 46 PUB. U. REP. 3d (PUR) 118, 128 (W. Va. P.S.C. 1962) (denying normalization of accelerated depreciation tax benefits and stating: "We believe the utility's position on this question is no more than fiction and that an income tax expense should not be allowed unless the tax is actually paid.").

147. See note 122 *supra* & note 199 *infra*.

148. See note 123 *supra*.

taxes as a current charge to support current government in favor of the abstract notion that taxes should be spread out evenly over a period of time, regardless of when the government collects them.

The flow-through of these tax benefits to ratepayers may seem to deprive the Treasury of revenue without providing sufficient incentive for plant expansion. The real reason for this lies not in the use of flow-through accounting, but once again in the absence of any compelling reason to provide utilities with this incentive. Unlike nonregulated industries, utilities are required to provide adequate service to all their customers and are guaranteed by the regulatory system a reasonable return on their investment for this service.[149]

Similarly, arguments for normalization based on accurate financial reporting practices may be appropriate for nonregulated industries that have elected to build new plants and thus have received tax benefits that may conceal the possibility of higher taxes in later years. These same arguments are not appropriate to utility ratemaking because the law requires that the company earn the same reasonable rate of return no matter what its future taxes may be.

Some commissions have required normalization for utility financial reporting, but not for rates;[150] however, this distinction is questionable. Although financial reporting may enable investors to compare a utility company with a nonregulated company, the comparison is meaningless because the possible future taxes are considerably more of a risk to the future earnings of nonregulated companies. Such comparisons imply to the investor that a utility should be as well prepared to handle future taxes out of current earnings as a nonregulated company, thus discouraging utility investors and leading to the demand for still higher current rates of return from the regulators to the detriment of ratepayers.

Professor Bonbright favored normalization of accelerated depreciation benefits in part because he believed that straight-line depreciation generally resulted in an overly retarded allowance for cost recoupment aside from tax considerations.[151] The

149. See notes 42 & 43 and accompanying text *supra*.

150. *E.g.*, Florida Tel. Co., 74 PUB. U. REP. 3d (PUR) 377 (Fla. P.U.C. 1968) (allowing normalization for rate setting but flow-through for accounting in order to increase the company's reported earnings and improve its capital generating capabilities); New England Tel. & Tel. Co., Nos. FC 2213; U 3178 (Me. P.U.C., filed June 10, 1977), *rev'd*, 390 A.2d 8 (Me. 1978).

151. J. BONBRIGHT, *supra* note 33, at 221.

argument is not a strong one. An electric plant is not like an automobile, which loses a big chunk of its value right at the beginning just because its resale value is reduced once it becomes "used." Resale value is not a primary consideration in plant depreciation. Moreover, issues concerning depreciation of utility assets have been thrashed out before regulatory commissions for years and if any reasonable argument for more rapid depreciation could be advanced, the companies would have brought it to the attention of the commissions before it became an accepted tax device. Recent studies show that for all industries, accelerated depreciation is slightly more accurate than straight-line depreciation for equipment alone, but less accurate than straight-line depreciation when applied to the depreciable real property improvements[152] that make up a large part of utility investment.

Bonbright's second reason for supporting normalization was that the practice of using accelerated depreciation in itself reduces the value of the asset more rapidly by using up the tax saving value in the early years.[153] This confuses the tax benefits with proper depreciation concepts relating to wear and tear or obsolescence. The "net of taxes" method of handling tax benefits divides the cost of the asset into two parts—the tax benefit and the remainder. The tax benefit is then depreciated on an accelerated basis and the balance of the cost is depreciated on a straight-line basis. The result is the same as normalization in terms of rates, but the concept more honestly labels what is being done as depreciation of a tax benefit. A tax benefit is difficult to accept as a depreciable asset when there is no assurance that the future tax structure and future taxable income will make that benefit worth anything. Moreover, although a tax benefit is depleted, it need not be replaced because of wear and tear or obsolescence. The tax benefit would not seem to be the kind of asset that is normally depreciable.

Finally, Bonbright stated that unless companies could normalize, at least to the extent of collecting the deferred tax, they would revert to straight-line depreciation and lose the tax benefit altogether.[154] He perceived this as harmful to consumers in the

152. Beidleman, *supra* note 107, at 389; Coen, *supra* note 107, at 72; Taubman and Rasche, *Subsidies, Tax Law and Real Estate Investment*, in 3 JOINT ECONOMIC COMM., THE ECONOMICS OF FEDERAL SUBSIDY PROGRAMS, 92d Cong., 2d Sess. 343, 343-44 (Comm. Print 1972).

153. J. BONBRIGHT, *supra* note 33, 221 *passim.*

154. *Id.*

long run. If he had foreseen, however, that accelerated depreciation would become a permanent part of the code rather than a temporary economic stimulus and that utility construction programs would result in billions of dollars of normalized taxes being charged to consumers annually, the possible reversion to straight-line depreciation might have seemed less alarming. Still, the argument that the ratepayers are better off even if only the company receives the tax benefit has validity. At first glance, the ratepayers apparently pay the same amount under normalization as under straight-line depreciation with no tax benefits. If the ratepayer has any preference, the money arguably should go to the government, resulting in either increased government services or lower taxes all around. Under normalization, however, the utility company's rate of return will probably be less,[155] lowering the total rates below what they would be without the tax benefit.

The enactment of section 167(*l*) in 1969 induced most commissions to accept normalization of accelerated depreciation benefits, at least for post-1969 expansion property, since the accelerated depreciation option is lost if normalization is not allowed.[156] In some instances, the regulators have openly acknowledged the utilities' need for increased cash flow because of inflation and heavy plant construction demands as the basis for allowing normalization.[157] To the extent that Congress has succeeded in requiring normalization, they have added to the cost of the tax benefit borne by the general federal income taxpayers an equal burden to be borne by the current ratepayers. This has undermined the entire ratemaking process by tempting the regulators to allow a fictitious tax expense in addition to or in lieu of the normal required rate of return.

It is not usually stated openly that the rate of return is lowered because of the additional cash flow to a utility from normalization, because such a statement would invite the Internal Revenue Service, probably with the assistance of the utility, to chal-

155. See note 165 *infra.*

156. *E.g.,* Memphis Light, Gas and Water Div. v. Federal Power Comm'n, 462 F.2d 853 (D.C. Cir. 1972), *rev'd on other grounds,* 411 U.S. 458 (1973); South Central Bell Tel. Co., 83 PUB. U. REP. 3d (PUR) 317 (Ala. P.S.C. 1970); Michigan Bell Tel. Co., 3 PUB. U. REP. 4th (PUR) 1, 15 (Mich. P.S.C. 1973); City of Akron v. Public Utils. Comm'n, 51 Ohio St. 2d 27, 364 N.E.2d 869 (1977); Pennsylvania Pub. Util. Comm'n v. Metropolitan Ed. Co., 96 PUB. U. REP. 3d (PUR) 113, 138 (Pa. P.U.C. 1972); Newport Gas Light Co., 85 PUB. U. REP. 3d (PUR) 257, 262-63 (R.I.P.U.C. 1970).

157. *E.g.,* Southern New England Tel. Co., 78 PUB. U. REP. 3d (PUR) 504 (1969).

lenge the use of rapid depreciation.[158] A commission need not make such damaging admissions in a period when rates of return are increasing; all a commission need do in a particular rate proceeding is to allow an increase in the rate of return slightly lower than it would have allowed without the availability of normalized taxes.[159] Difficulties arise here because this makes it impossible to calculate and evaluate the real rate of return; it ignores the statutory requirements for rate of return, it deceives the public into believing that a lower return is being granted than is actually the case, and it conceals from current ratepayers that they are paying money for taxes from which they will not derive any benefits.

In summary, the simplest solution to the current problem would be for Congress to exclude regulated industry from the benefits of accelerated depreciation. Failing this, Congress could

158. See note 90 and accompanying text *supra.*

159. It has occasionally been suggested in the cases that the flow of cash caused by normalization should result in a lower required rate of return on equity. *E.g.*, El Paso Natural Gas Co., 22 F.P.C. 260, 267 (1958), *remanded,* 281 F.2d 567 (5th Cir.), *cert. denied,* 366 U.S. 912 (1960) (deferred taxes might lower company's cost of money and allow a lower rate of return) (dictum); City of Los Angeles v. Public Util. Comm'n, 15 Cal. 3d 680, 704-05 n.42, 542 P.2d 1371, 1387-89 n.42, 125 Cal. Rptr. 779, 795-96 n.42 (1975) (dictum); Mountain Fuel Supply Co., 76 PUB. U. REP. 3d (PUR) 277, 288, 294 (Utah P.S.C. 1968) (refusing to impute accelerated depreciation to a straight-line company, but considering this is setting lower rate of return).

President Batinovich and Commissioner Sturgeon of the California Public Utilities Commission in a recent article, *Federal Taxes and Regulated Utilities: A Solution to the Dilemma, printed at Hearings Before Comm. on Ways and Means, President's Tax Reduction and Reform Proposals,* 95th Cong., 2d Sess., part 4 of 9, p. 2039 (1978), recommended the adoption of H.R. 8897, 95th Cong., 1st Sess. (1977); see note 49 *supra.* They stated several times that commissioners in fact take account of "normalization" funds available in performing their statutory duty to set a fair rate of return. Batinovich & Sturgeon, *supra* at 2046, 2057. The point is also made in recent testimony of Dr. Charles Cicchetti, Chairman of the Wisconsin Public Service Commission. *Hearings Before Comm. on Ways and Means, President's Tax Reduction and Reform Proposals,* 95th Cong., 2nd Sess. part 4 of 9, p. 1890 (1978). He stated that some regulators oppose change in the tax laws precisely because they believe that the resulting higher rates of return would be politically impossible. *Id.* at 1892. *See also* testimony of Chairman Clement of the Tennessee Public Service Commission. *Id.* at 1894. Commissioner Sturgeon of California pointed out the absurdity of the situation when he related that a representative of A.T.T. stated that he was not overly anxious to reduce the corporate tax to 44% because of reduction of the tax benefits. *Id.* at 1889-90.

Perhaps the most convincing evidence of this adjustment is contained in a study prepared by one of the guiding forces behind normalization, Arthur Andersen & Co. On the basis of a study prepared by Duff & Phelps, Inc., utility financial analysts, the Andersen analysts conclude that the overall cost of capital to utilities is properly reduced from ¼ to ½ a percentage point by use of full normalization in contrast to flow-through. Andersen Co. Study, *supra* note 80, Part II.C. at 29, 64, 68, 72, 74. Although ½ a percent does not seem like a great deal, it amounts to $10 million of pre-tax revenue annually on a $1 billion rate base.

repeal section 167(*l*) and allow complete flow-through. Politically, more hope may lie in the enactment of proposed legislation replacing the income tax on utility companies with an excise tax.[160] In the meantime, a number of jurisdictions have continued to flow through the tax savings on pre-1970 and post-1969 replacement property.[161] One commission has counterbalanced normalization benefits with an automatic deferred tax annual adjustment clause.[162] Another possible device would be to use the deferred tax reserve to eliminate the need for cash working capital.[163] Probably the most common regulatory response is to allow normalization and either openly or tacitly hold down the rate of return.

III. NORMALIZATION OF OTHER TAX DEDUCTIONS AND COMPREHENSIVE INTERPERIOD INCOME TAX ALLOCATION

The simplest form of normalization is that related to items expensed for tax purposes but amortized for ratemaking purposes. No particular language in the tax code prescribes normalization for these items, and they are not, as is the case with accelerated depreciation and investment tax credit, tied to any particular tax subsidy. The opportunity for normalization exists simply because these items may be currently expensed for tax purposes but not for ratemaking purposes; in any test year computation there is a deductible tax expense for ratemaking purposes that can either be flowed through to the ratepayer by reducing the revenue requirement or collected from the ratepayer and a reserve established to reduce revenues in future years.

Many of these current tax deductions relate to construction

160. See note 49 *supra.*

161. *E.g.*, Mars Hill & Blaine Water Co., 19 PUB. U. REP. 4th (PUR) 380 (Me. P.U.C. 1977) (ordering flow-through to the extent that tax benefit will not be lost and placing burden on company to show that tax benefit will be lost).

162. See notes 88-103 and accompanying text *supra.*

163. Many jurisdictions set off accrued taxes against any working capital requirement. Union Elec. Co., 81 PUB. U. REP. 3d (PUR) 265, 269 (Mo. P.S.C. 1969) (tax accruals sufficient to provide working capital); Southern New England Tel. Co., 78 PUB. U. REP. 3d (PUR) 504, 514 (Conn. P.U.C. 1969) (disallowing working capital from rate base because of normal delay in paying of income taxes, collection of excise taxes, and advance billing procedures available). By the same reasoning the deferred tax amount represents funds that are available for use as working capital. An argument can be made that the deferred tax reserve is already earmarked for construction work in progress. When normalized taxes are allowed as a current expense, however, there is a regular incoming cash flow that should be available for working capital until the time that it is turned over into more permanent expenditures.

work in progress. Regulatory authorities often do not permit utility companies to recover a return on property that is not yet used in the production of service.[164] Partially completed new plants are therefore not included in the rate base until they go into actual service. Similarly, expenses incurred for construction work in progress are not allowed as current operating expenses, but must be amortized as part of the cost of the plant over its useful life after completion. Such expenses include many items, such as wages paid for construction workers and equipment costs for equipment used in construction, which have to be capitalized for income tax purposes.[165] No problem is created by these items; however, other construction costs can be deducted currently as a tax expense even though the plant is not completed. These include state and local real and personal property taxes, current employee pension contributions, sales and use taxes, and interest paid on debt used to finance construction.[166] Similar items exist which are not related to new construction, such as certain repairs that can be expensed for tax purposes but must be amortized for ratemaking purposes.

The Federal Power Commission took the lead in allowing utility companies to normalize these tax benefits. FPC Order 530[167] provides for comprehensive interperiod income tax allocation,[168] allowing normalization of all items if the tax is found to

164. *See, e.g.*, ME. REV. STAT. tit. 35, § 52 (1964) (requiring fair return on "reasonable value" of property used or required to be used in its service to the public); N.Y. [PUB. SERV.] LAW § 66.16 (McKinney 1955) (rates based on "fair value of the property used and useful in said service"). See note 6 *supra* (regarding the allowance or disallowance of construction work in progress in the rate base).

165. In Commissioner v. Idaho Power Co., 418 U.S. 1 (1973), the Supreme Court held that depreciation expense on transportation equipment used for construction must, to the extent the equipment was so used, be amortized over the life of the plant constructed rather than over the life of the equipment. I.R.C. § 263(a)(1) disallows a deduction for amounts "paid out for new buildings or for permanent improvements. . . ." Under I.R.C. § 161 the Court read this as an exception to I.R.C. § 167 and held that when amortization was required by generally accepted accounting principles and made mandatory by the state regulatory commission, the current depreciation expense, even though not a cash expenditure, should be considered as "paid out" under § 263(a)(1). 418 U.S. at 16-19.

166. Although interest as compared to depreciation, see note 165 *supra*, is unquestionably "paid out," the Internal Revenue Code does not disallow the deduction of current interest expense on funds borrowed for construction work in progress. If the Internal Revenue Code treatment consistently required amortization of these items, the ratemaking problem discussed here would disappear.

167. F.P.C. Order 530, 53 F.P.C. 2123 (1975).

168. The lengthy discussion in Order 530 (with all its revisions and related orders) leaves one unsatisfied in part because the phrase "comprehensive interperiod income tax allocation" is interpreted to include a number of different items. It is assumed without

occur in a different period than when the income is deemed to be earned, including accelerated depreciation and asset depreciation range benefits.[169]

In Order 530, the FPC gave four reasons for adopting normalization. First, Congress had expressed its views favoring normalization of liberalized depreciation benefits under section 167(*l*).[170] Second, cash shortage was perceived in the gas and electric power industries, creating difficulties in raising the capital necessary for growth. Third, the FPC desired to increase cash flow and reduce external financing requirements for these companies. Last, they desired to increase the financial stability of the companies and improve fixed charge coverages.[171] Under the terms of the original order, normalization was to be allowed in ratemaking on a case-by-case basis, dependent on a factual showing by the company of a tax deferral rather than a true tax saving.[172] Further, normalization accounting would not be required in jurisdictions in which normalization was not allowed for rates.[173]

FPC Order 530A, entitled "Order Denying Applications for Rehearing and Clarifying Prior Order,"[174] emphasized the need for a factual showing of a tax deferral,[175] specifically stating that the need for increased cash flow and better fixed charge coverage, although relevant, would not justify normalization without such a showing.[176] Moreover, the FPC stated that "in

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further discussion that the "later" tax relates to "earlier" earnings and that there is thus involved a "timing difference." Once this assumption is made the rest of the discussion seems superfluous. Yet, the soundness of the assumption as applied to each item is never considered. The order specifically includes tax benefits associated with depreciation (including class life asset depreciation range), accelerated amortization on certified defense facilities (I.R.C. § 168), extraordinary property losses amortized for ratemaking purposes, research and development expenditures when amortized, deferred gain or loss from sales of utility plants, repair allowance, amortized regulatory commission expenses, capitalized construction costs (including interest, pension costs, taxes), and deferred fuel costs. 53 F.P.C. at 2124-25.

169. The commission, prior to Order 530, had in some instances continued to require flow-through on pre-1970 property and post-1969 replacement property when permitted to do so by I.R.C. § 167(*l*). See note 77 *supra*. It has now opted for normalization in all instances.

170. F.P.C. Order 530, 53 F.P.C. at 2126.

171. *Id.* at 2127.

172. *Id.* The order speaks of a "factual showing," but does not clearly define the issue to be resolved.

173. *Id.*

174. F.P.C. Order No. 530A, 8 FED. POWER SERV. (M. BENDER) 5-224 (Jan. 19, 1976).

175. *Id.* at 5-227-28.

176. *Id. See also* El Paso Natural Gas Co. v. Federal Power Comm'n, 281 F.2d 567, 573 (5th Cir.), *cert. denied*, 366 U.S. 912 (1960) (holding that mineral depletion tax

general, the proper place to consider issues such as the need for increased cash flow, financial stability of the utility, fixed charge coverages and other risks associated with a utility's operation is *in the area of setting a just and reasonable rate of return on common equity . . . .*"[177]

This disposed of three of the original arguments of Order 530, but did not address the first argument based on congressional preference for normalization. The FPC did well to abandon this one, because the congressional preference for normalization of accelerated depreciation might well imply a lack of preference for normalization in the other areas in which Congress had said nothing.[178] Moreover, the clear tax incentive motivations underlying section 167(*l*) belie any notion that this is a normal accounting procedure. Normalization of accelerated depreciation had been advocated and adopted in most jurisdictions as an exception to the usual rules, rather than an example thereof. Perhaps the Commission at this point sensed its tenuous position, because it proposed the argument that normalization prevents the shifting of the tax burden to future consumers in return for "artificially lower rates" today. This, of course, assumes that today's customers are the proper persons to pay for tomorrow's taxes.[179]

FPC Order 530B, an "Order Revising Prior Orders,"[180] redefined the need for a specific factual showing supporting normalization in each rate proceeding to such an extent that it was practically eliminated.[181] The Commission held out a straw to the consumers by providing that normalization will not be permitted when the difference between book and tax recognition is a "permanent" difference,[182] but included in this category only items such as municipal bond interest, political contributions, and depletion allowances.[183] The FPC thus reversed its previous order requiring that a tax deferral rather than a tax saving be

benefits should be flowed through, although exhaustion of a wasting asset was a factor required to be considered in setting a rate of return).

177. Order 530A, *supra* note 174, at 5-228 (emphasis added).

178. *See* Treas. Reg. § 1.167(*l*)-1(a)(1) (1974); H.R. REP. No. 91-782, 91st Cong., 1st Sess. (1969); Pennsylvania Elec. Co., 10 PUB. U. REP. 4th (PUR) 351, 353-54 (1975) (disallowing normalization of items not affected by I.R.C. § 167(*l*)).

179. Order 530A, *supra* note 174, at 5-230-31; see note 124 and accompanying text, *supra*.

180. F.P.C. Order No. 530B, 10 FED. POWER SERV. (M. BENDER) 5-187 (July 6, 1976).

181. *Id.* at 5-194.

182. *Id.* at 5-189, 193.

183. *Id.* at 5-188.

shown, but allowed normalization in any case in which there is a so-called "timing" difference.[184] The Commission removed the factual issue of whether in a particular instance the deferrals would amount to a long-term or permanent savings on the basis of a theoretical conclusion that "if the tax effect of each year's construction is spread equitably over the plant's life, the aggregate result cannot but be equitable."[185]

The Commission evidently still felt a lack of adequate theoretical underpinnings, for it again addressed the reasons for normalization in Order 530B. This time it went to some length to develop the position that the decision whether to use normalization or flow-through does not involve a general issue of law, but only a discretionary choice of accounting methods.[186] It then reiterated as reasons for the general rule in favor of normalization the need for cash flow, reduced external financing, increased financial stability, and improved fixed charge coverage.[187] Aside from the Commission's abandonment of this line of reasoning in Order 530B, all of these factors are particularly well suited for examination on a case-by-case basis; they have nothing to do with accounting principles.

The question of which ratepayers should pay the tax is given only perfunctory attention in Order 530B, but normalization is justified on the basis that the tax should appropriately be spread over all years.[188] This reasoning ignores the action of Congress in assessing and collecting taxes in a particular year and elevates the Commission over Congress, allowing it to spread the economic impact of taxes as it sees fit.

Finally, in its "Order Denying Rehearing of Order No. 530B," the FPC again discounted the financial stimulus motivation for normalization as embracing relatively "short term" changes in the industry regulated and relied primarily on the theory that normalization is "the proper and preferable method for ratemaking and accounting purposes."[189] Thus, in the end the FPC has eliminated all bases for the rule except the conclusion that it is "good accounting." It made no real examination of comprehensive interperiod tax allocation and its applications to

184. *Id.*
185. *Id.* at 5-192.
186. *Id.* at 5-190.
187. *Id.* at 5-191-92 (quoting Order 530A, note 174, *supra*).
188. *Id.* at 5-192.
189. F.P.C. Docket # R-424, R-446 (Sept. 3, 1976).

discover if indeed it does correctly allocate expenses any better than flow-through. Moreover, it sets aside normal ratemaking considerations in favor of an arbitrary power to distribute expenses evenly over the years.

The court of appeals recently reversed the FPC orders adopting comprehensive interperiod tax allocation. It held that the orders neither assessed the consequences of the action for the industry nor indicated "fully and carefully" their purposes. In essence, the court found insufficient evidentiary and policy bases for the order in the record, and therefore remanded it.[190]

State commissions have been more cautious in adopting normalization of tax benefits when not required to do so by the tax codes. Some have rejected it altogether, and others have allowed it for certain items.[191] In at least one instance, the pressure brought to bear on state regulatory practice by section 167(*l*) and accelerated depreciation seems to have opened the door for further normalization.[192]

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190. Public Systems v. Federal Energy Regulatory Comm'n, Nos. 76-1609 & 76-1830, slip op. at 13-18 (D.C. Cir. Feb. 16, 1979).

191. Normalization rejected: Iowa Power and Light Co., 6 PUB. U. REP. 4th (PUR) 446, 453-56 (1974) (Iowa State Comm. Comm'n 1974) (actual tax expense rule requires flow-through, distinguishing earlier case that by stipulation allowed normalization of interest deduction for interest related to construction work in progress because company had a serious cash flow problem); New England Tel. & Tel. Co., 84 PUB. U. REP. 3d (PUR) 130, 167 (Mass. Dep't of Pub. Utils. 1970) (includes interest on capital costs of construction work in progress as a current tax deduction); Michigan Consol. Gas Co., 79 PUB. U. REP. 3d (PUR) 375, 387-88 (Mich. Pub. Util. Comm. 1969) (exceptions to the rule of actual taxes should be granted, if at all, only in rulemaking proceedings with public hearings); Midstate Tel. Co., 10 PUB. U. REP. 4th (PUR) 88, 94 (N.Y.P.S.C. 1975); Montana-Dakota Util. Co., 21 PUB. U. REP. 4th (PUR) 1, 12-14 (S.D.P.U.C. 1977).

Normalization allowed: Ala. Power Co., 97 PUB. U. REP. 3d (PUR) 371, 376 (Ala. P.S.C. 1972) (allowing partial normalization of current deductions relating to construction work in progress); Union Elec., Case No. ER-154 (Mo. P.S.C., filed Jan. 19, 1978); Natural Fuel Gas Distrib. Co., 17 PUB. U. REP. 4th (PUR) 138, 152 (N.Y.P.S.C. 1976) (deferring tax benefits associated with unfinished construction); Pennsylvania Pub. Util. Comm'n v. Duquesne Light Co., 5 PUB. U. REP. 4th (PUR) 202, 241-42 (Pa. P.U.C. 1974) (deduction related to interest on construction work in progress deferred). The Andersen Co. Study, *supra* note 80, shows 23 states normalizing and 24 flowing-through the item of interest related to construction, and with respect to other items shows 28 normalizing to 21 flowing-through. *Id.* at Part IV-47. The NARUC Report, *supra*, note 80, shows three categories: costs of removal, repair allowance, and "all other," finding 6 jurisdictions (excluding the Virgin Islands) requiring flow-through of each of the three categories and 10, 11, and 7 jurisdictions, respectively, requiring normalization of these three categories. *Id.* at 505.

192. In Cincinnati Gas & Elec. Co. v. Ohio Pub. Util. Co., 173 Ohio St. 473, 184 N.E.2d 84 (1962), the court relied on the actual tax principle and required flow-through of accelerated depreciation tax benefits. After the present I.R.C. § 167(*l*) was enacted in 1969, the Ohio Commission began allowing normalization in appropriate situations to

The use of gimmicks or devices simply to improve a company's financial attractiveness as an investment makes a mockery of the traditional ratemaking process. If a company needs a higher rate of return to attract the necessary capital, that rate should be allowed in a straightforward manner. The inclusion of artificial expenses in the cost of services confuses the ratepayer and investor alike.[193]

An additional argument used to justify normalization of these current tax deductions is that since for ratemaking purposes the expense must be amortized over a future period, it follows that the tax benefit associated with the expense should be matched with the expense by amortizing it over the same period.[194] This argument does not adequately take into consideration ratemaking practices. Although the items in question may not be chargeable directly to ratepayers as a cost of service until future years, the current ratepayers are in a very important sense paying for the expense presently. The regulatory duty to provide regulated utility companies with a rate of return sufficient to raise the capital necessary to provide the services demanded by the public includes a duty to provide a sufficient return to attract capital needed to build the necessary facilities to supply reasonably foreseeable increases in demand.[195]

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prevent the company from losing federal tax benefits, and the Ohio Supreme Court affirmed, reversing its earlier position against normalization. City of Akron v. Ohio Pub. Util. Comm'n, 51 Ohio St. 2d 27, 364 N.E.2d 869 (1977). A statute was enacted permitting normalization when necessary to preserve a tax benefit. OHIO REV. CODE ANN. § 4909-15(A)(4) (Page Supp. 1978). Following all this, the Ohio Commission has now allowed comprehensive interperiod allocation at least for new plant additions. Dayton Power & Light Co., 21 PUB. U. REP. 4th (PUR) 376, 388-91 (Ohio P.U.C. 1977); Dayton Power & Light Co., 21 PUB. U. REP. 4th (PUR) 295, 300-03 (Ohio P.U.C. 1977).

193. Two commissions have openly relied on the need for cash flow as the sole reason for allowing this normalization. One indicated that the ruling should not be considered precedent on the issue. Iowa Elec. Light & Power Co., 2 PUB. U. REP. 4th (PUR) 288, 294 (Iowa St. Comm. Comm'n 1973). The other allowed normalization of interest expense tax deductions but required flow-through of other tax benefits associated with unfinished construction. Kansas Power & Light Co., 20 PUB. U. REP. 4th (PUR) 55, 59-60 (Kan. St. Corp. Comm'n 1977). *Contra,* Hawkeye State Tel. Co., 2 PUB. U. REP. 4th (PUR) 166 (Iowa St. Comm. Comm'n 1973). On the distortion of rate of return caused by tax normalization, see note 159 *supra.* The confusion and obfuscation of the true rate of return made necessary by normalization recurred in recent testimony before the Ways and Means Committee. *See Hearings Before the House Ways and Means Comm.*, note 159 *supra,* at 1889 (Cal. Comm'r Sturgeon), 1894 (Tenn. Comm'r Clement), 1891 (Wisconsin Comm'r Cicchetti), 2035, (Cal. Comm'r Batinovich).

194. Pennsylvania Pub. Util. Comm'n v. Duquesne Light Co., 5 PUB. U. REP. 4th (PUR) 202, 241-42 (Pa. P.U.C. 1974).

195. Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603, 607 (1944);

Although an item of new construction may not yet be part of rate base or chargeable as an operating expense for rate purposes, the company must still currently pay for that item. The current ratepayers, by providing a sufficiently high rate of return, have enabled the company to raise the money necessary to pay for it. When the item becomes an allowable expense or, more correctly, when it is added to the rate base and subsequently depreciated, the future ratepayers will have to pay its replacement cost, but it is the current ratepayers who have provided a return sufficient to allow the company to acquire the new equipment. A new plant will be fully depreciated over its useful life starting with the date it becomes operational, but that depreciation expense will merely replace the capital needed to build it. This capital is and must be raised before the plant begins functioning, and it is during this period of capital raising that investors will be concerned with the rate of return. If demand lags so that no new construction is necessary for a significant period of time, it is almost certain that a lower rate of return will suffice in the future since the company would be in a stronger financial position. The need for costly new plants is largely what has caused the demand for higher returns and higher rates on the part of electric power companies, and the present ratepayers are already paying these higher rates.[196]

The Iowa State Commerce Commission, in *In re Hawkeye State Telephone Co.*, stated:

> The Uniform System of Accounts classifies construction work in progress as utility plant, and permits its costs to include cost of capital during the lag until revenues are obtained. The company reduces its income taxes for interest capitalized during construction. This savings should be passed along to the ratepayer the same year it is realized. The full amount of interest charged to construction work in progress is included in rate base when the construction projects are placed in service. If we were to fail to recognize this tax saving now, the ratepayer would be penalized.
>
> The contention that the ratepayer does not bear a cost for construction work in progress until the finished project goes into service is specious. Even though unfinished construction work in progress is not included in rate base, the capital costs are

Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of W. Va., 262 U.S. 679, 693 (1923). See also notes 42-43 *supra*.

196. See note 5 *supra*.

included in determining the cost of capital. There is no requirement that ratepayers pay a return on any property not in service. Nevertheless, the cost of capital used in fixing a fair rate of return may be affected by unfinished construction.[197]

As with accelerated depreciation, the argument can be made that by allowing the current deduction for taxes Congress is postponing the tax which would fall on today's ratepayers and placing it on tomorrow's.[198] The argument is even weaker in this setting, however, because under section 167 the tax deduction prior to the provision for accelerated methods did in fact result in higher taxes in the earlier years. In this instance, Congress has not created a tax deferral for the deliberate purpose of stimulating investment. The Internal Revenue Code simply treats some charges in a different way than the ratemakers. The argument that this somehow unfairly benefits the early year ratepayers is farfetched. By its nature an income tax is based on the amount of current income, as adjusted by exclusions, deductions, and exemptions, and computed by the appropriate tax rate. The tax is paid to a government to enable that government to provide services to its current constituents.

Deferral or normalization of the tax benefit results in a charge to current taxpayers for possible future tax payments. These future payments are dependent on the tax situation, including earnings, deductions, credits, tax rates, and ultimately the level of government spending during the period when the items are being amortized. It is therefore appropriate that the ratepayer at those times be charged with the amounts necessary to pay those taxes. To normalize is to charge today's ratepayers with tomorrow's possible taxes.[199]

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197. 2 PUB. U. REP. 4th (PUR) 166, 177 (1973); *accord,* New England Tel. & Tel. Co., 84 PUB. U. REP. 3d (PUR) 130, 167 (Mass. Dep't of Pub. Utils. 1970) (holding flow-through of interest deduction related to capital cost of unfinished construction not inconsistent with excluding unfinished construction from rate base); Midstate Tel. Co., 10 PUB. U. REP. 4th (PUR) 88, 94 (N.Y.P.S.C. 1975) ("Nevertheless, we admit that there is some force to the logic of Midstate's proposal to identify income tax savings to the projects which give rise to those savings. By the same logic, however, we should not charge present customers the higher costs of capital associated with the utility's need to expand capacity to meet future demand, yet we do.").

198. Alabama Power Co., 97 PUB. U. REP. 3d (PUR) 371, 376 (Ala. P.S.C. 1972) (allowing partial normalization because the flow-through of reduced taxes shifted the burden of the resulting increased future taxes to future customers).

199. "Flow-through, not normalization, produces equity between current and future ratepayers." Iowa Power & Light Co., 6 PUB. U. REP. 4th (PUR) 446, 454 (Iowa St. Comm. Comm'n 1974); *accord,* Northwestern Pub. Serv. Co., 22 PUB. U. REP. 4th (PUR)

Adding to this the absence of a legislative enactment, comparable to section 167(*l*),[200] requiring normalization of these items, it is surprising that so many regulators have allowed it. Some commissions apparently have been convinced of a need for increased utility capitalization and convinced that the public will rebel at the allowance of the real rate of return necessary to raise this capital, resulting in the legitimization of a scheme to conceal from the ratepayers how much return the utilities are really receiving.[201]

IV. INVESTMENT TAX CREDITS

The investment tax credit is similar to accelerated depreciation for ratemaking in that it is also a tax subsidy through which Congress specifically sought to encourage investment in new facilities.[202] IRC section 46 creates a credit against taxes for up to

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60, 82 (S.D. Pub. Util. Comm'n 1977). See notes 123-50 and accompanying text *supra*.

200. *See* Northwestern Pub. Serv. Co., 22 PUB. U. REP. 4th (PUR) 60, 82 (S.D. Pub. Util. Comm'n 1977) (flow-through required because actual taxes paid should constitute the basis for company's tax allowance unless otherwise precluded by federal law).

The issue of normalization of state income tax benefits is not discussed in the text. The argument made in Parts II.A.-III *supra* applies also to state tax deductions. Immediate flow-through of such benefits is required for the same reasons. City of Los Angeles v. California Pub. Util. Comm'n, 7 Cal. 3d 331, 497 P.2d 785, 102 Cal. Rptr. 313 (1972); Pacific Tel. & Tel. Co., 95 PUB. U. REP. 3d (PUR) 1 (Cal. P.U.C. 1972); Gulf States Util., 20 PUB. U. REP. 4th (PUR) 145, 153-54 (La. P.U.C. 1977); Bangor Hydro-Elec. Co., 16 PUB. U. REP. 4th (PUR) 244, 253 (Me. P.U.C. 1976); Central Me. Power Co., 15 PUB. U. REP. 4th (PUR) 455 (Me. P.U.C. 1976); *accord*, Mars Hill & Blaine Water Co., 19 PUB. U. REP. 4th (PUR) 380, 387-88 (Me. P.U.C. 1977) (rejecting the argument that I.R.C. § 167 (*l*) will deprive the company of the tax benefits of accelerated depreciation if the company is not permitted to normalize state income tax benefits due to accelerated depreciation, and ordering flow-through of the state benefits). The absence of a statutory requirement for normalization of state tax benefits is particularly convincing because there is a multiplier effect on revenue requirements in normalizing state taxes. Such normalized taxes are not deductible from federal income taxes.

201. See note 159 *supra*.

202. The investment tax credit, I.R.C. § 46, was originally enacted as § 2 of the Revenue Act of 1962, Pub. L. No. 87-834, §§ 2(a) - (b), 76 Stat. 960 (1962). President Kennedy recommended the tax credit to fight recession, stimulate employment, and increase export markets. He felt that the additional expenditures on plant and equipment would create more jobs in the "capital goods industries" and that these workers would create still more jobs in consumer goods and services industries. H.R. REP. No. 1447, 87th Cong., 2d Sess. 17 (1962).

Arguably this act encourages investment in automated equipment, perhaps reducing employment. Discussion of tax benefits from the standpoint of economic theory related to fiscal policy is beyond the scope of this article. See, however, Brown, *The New Depreciation Policy Under the Income Tax*, 8 NAT'L TAX J. 81 (1955) (recommending an investment tax credit) and Chase, *Tax Credits for Investment Spending*, 15 NAT'L TAX J. 32 (1962) (recommending lower interest rates or higher personal income taxes with reduced

eleven percent of the costs of constructing or acquiring qualifying new facilities.[203] This credit is not balanced by any future higher tax and it unquestionably results in a tax saving rather than a tax deferral. A ratemaking commission can either flow through the tax benefit to current ratepayers, spread the benefits out over the life of the asset to which it is related, or allow the ratepayer to be charged for the tax savings while the stockholders retain all the benefits.

The theoretical arguments favoring immediate flow-through of the tax reduction are much the same as those made in the preceding sections of this article. Normalization results in charging tomorrow's taxes to today's ratepayer. There were attempts to justify normalization of accelerated depreciation benefits on

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taxes on business income as preferable either to accelerated depreciation or the investment tax credit).

203. The 1962 Act provided a 7% investment tax credit for investment in equipment and machinery, but only 3% for public utilities. In proposing the investment tax credit in 1961 Secretary of the Treasury Dillon recommended that utilities be excluded because incentives are not needed for regulated industries, which are legally required to fill public demand. *Detailed Explanation of the President's Recommendations Contained in His Message on Taxation: Hearings Before the House Ways & Means Comm.*, 87th Cong., 1st Sess. 256-57 (1961). Perhaps the reduced credit for utilities was a compromise with this view.

In 1966 the investment tax credit was suspended until Dec. 31, 1967. Pub. L. No. 89-800, 80 Stat. 1508, 1514 (1966). The suspension was lifted, however, as of March 9, 1967. Pub. L. No. 90-26, 81 Stat. 57 (1967). It was repealed altogether in 1969, Pub. L. No. 91-172, tit. VII, § 703, 83 Stat. 660 (1969), and reenacted in 1971 as the Job Development Investment Credit, at which time the credit allowed to public utilities was increased to 4%, Revenue Act of 1971, Pub. L. No. 92-178, tit. I, § 105, 85 Stat. 497 (1971).

In the Tax Reduction Act of 1975 the limit on the credit was raised to 10% for all companies including utilities, for property placed in service after Jan. 1, 1975, and before January 1977. Pub. L. No. 94-12, tit. III, § 301(1)(A), 89 Stat. 26, 36. The credit was extended until January 1981 under the Tax Reform Act of 1976 together with an extra 1% or 1 ½%. Pub. L. No. 94-455, 90 Stat. 1580 (1976) (codified at § 802(a)(2)). Certified pollution control facilities under I.R.C. § 169 originally did not qualify for investment tax credit. I.R.C. § 169(h) (1970). However, a 50% credit is allowed for facilities placed in service after Dec. 31, 1976. I.R.C. § 46(c)(5).

The amount of the credit is generally limited to the $25,000 in tax liability plus 50% of the liability in excess of $25,000; however, utilities were authorized for credit of up to 100% in 1975-76, 90% in 1977, 80% in 1978, 70% in 1979, and 60% in 1980. I.R.C. § 46(a)(3) and (7). The Revenue Bill of 1978 raises the regular limit by 10% per year to a maximum of 90% for all companies in 1982 and thereafter. It also includes buildings as well as machinery as property qualifying for the credit. Utility companies will retain the 80% limit for 1978 and the 70% limit for 1979 and will thereafter be treated as other companies. I.R.C. § 46(a)(3)-(7).

Excess credits can presently be carried back 3 years or forward 7 years. I.R.C. § 46(b)(1)(A)-(B). Moreover, companies can now elect to use their credit in advance of placing the property in service with respect to any plant which will take more than 2 years to build and will have a useful life of at least 7 years. I.R.C. § 46(c).

the theory that the Internal Revenue Code, by moving the amount of depreciation around in time, simply changed the year of the tax, which the regulators at the Congress' insistence have changed back as far as the ratepayers are concerned. The investment tax credit was entirely new and did not originally relate in itself to any particular period. The logical result was to reduce rates in the year in which the benefit was received.[204]

The original 1962 Act, however, required that the rate base be reduced by the amount of deferred income tax credit. This could have been read as indicating an intention that the credit not reduce current revenue requirements, because if revenue is reduced and the rate base reduced also, the company's investment stimulus would be balanced by the immediate loss of income from the ratepayers. On the other hand, Congress may have simply intended to require complete flow-through because utilities do not need the incentive.

In an effort to preserve some of the incentive, a ratemaking scheme was devised and adopted in a few jurisdictions which flowed through forty-eight percent of the investment tax credit immediately, representing the amount that would have to be repaid to the government at a fifty-two percent tax rate over the life of the asset due to the reduced rate base and resulting reduced depreciation allowance.[205] In 1964, Congress acted in two ways. It eliminated the requirement that the rate base be reduced, encouraging immediate flow-through,[206] but at the same time it prohibited federal regulatory agencies from immediately flowing through the full benefit.[207] By 1965, the state commissions were evenly split between those that required immediate flow-through and those that required normalization.[208]

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204. Accounting Procedure for Investment Tax Credit, 49 PUB. U. REP. 3d (PUR) 190 (N.Y.P.S.C. 1962); *accord,* Torrington Water Co., 48 PUB. U. REP. 3d (PUR) 1, 5 (Conn. P.U.C. 1963).

205. Hawaiian Elec. Co., 48 PUB. U. REP. 3d (PUR) 245, 247 (1963).

206. Revenue Act of 1964, Pub. L. No. 88-272, tit. II, § 203(a), 78 Stat. 33 (1964).

207. The FPC had ordered full flow-through investment tax credit under 1962 Amendment to I.R.C. Accounting Treatment by Public Utility Licenses and Natural Gas Companies, 31 F.P.C. 175, Interim Order No. R-232 (1964). In 1964, Congress provided that utilities could not flow-through the credit more than ratably over the useful life of the property for federal ratemaking purposes. Revenue Act of 1964, Pub. L. No. 88-272, tit. II, § 203(e)(1), 78 Stat. 33 (1964). "Ratability" is defined to allow a yearly flow-through in proportion to the depreciable life of the property (without allowing accelerated flow-through of investment tax credit for companies using accelerated depreciation). *See* I.R.C. § 46(f)(6).

208. *What Others Think: Digest of Depreciation and Amortization Practices,* 75 PUB.

The Accounting Principles Board, with some dissent, adopted a preference for normalization, stating:

> In our view the relevant materials support the interpretation that the investment credit is an administrative procedure to permit the taxpayer to withhold the cash equivalent of the credit from taxes otherwise payable and that it is not an element entering into the computation of taxes related to income of the period.[209]

This preference was later modified by recognition that flow-through was also acceptable.[210] The quoted language seems to contradict what Congress actually did, which was to create a current income tax credit.

Proponents of normalization of investment tax credit may also point out that it seems unfair to afford all of the benefit to the current ratepayers when the property may be used for twenty or thirty years. This may be acceptable if it is the function of regulatory commissions to spread utility tax expenses over the years in an equitable manner; however, it violates the rule of actual taxes built into the ratemaking method.

The legal as well as equitable duties of the regulator are best performed by simply letting the taxes fall in the year that they are collected, leaving it to the legislatures to balance tax collection with government spending. The legislative story, however, did not end in 1964. As with accelerated depreciation, Congress has intervened to require a form of normalization of investment tax credits. In 1971, Congress mandated certain practices by denial of the credit unless the local ratemaking agencies complied with certain options given to the utility companies. Under one option, reduction of the cost of service by the reduced taxes is prohibited, but the company may reduce its rate base by the amount of the credit provided the rate base is ratably restored.[211] This treatment is more favorable to the companies than what might be called "regular normalization," under which the de-

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UTIL. FORT. 62, 64-65 (1965). Some states followed the 52%-48% division, and some left it up to the companies.

209. [1972] 2 ACCOUNTING PRINCIPLES BOARD, APB ACCOUNTING PRINCIPLES: ORIGINAL PRONOUNCEMENTS (CCH) Op. no. 2, par. 8, at 6507 (issued 1962).

210. *Id.* Op. no. 4, par. 10, March 1964, at 6574.

211. I.R.C. § 46(f)(1). The limitations discussed in the text were added by the Revenue Act of 1971, Pub. L. No. 92-178, tit. I, § 105(6), 85 Stat. 497, 503 (1971), creating Code § 46(e), which was redesignated I.R.C. § 46(f) by the Tax Reduction Act of 1975. Pub. L. No. 94-12, tit. III, § 302(a), 89 Stat. 26, 40 (1975).

ferred taxes would be eliminated from the rate base altogether without later restoration. It appears that the amount restored cannot be depreciated, but becomes a permanent fund.[212]

A second option allows ratable flow-through of the credit, reducing cost of service over the life of the asset with no reduction in the rate base either currently or in the future.[213] This method is also better than ordinary normalization. The rate base should be adjusted downward by the amount of the deferred tax outstanding at any time. An initial reduction in the rate base would be restored as the credit is used up. Under this option, the company is allowed to collect the full amount of the tax benefit from the current ratepayers in the first year, and perhaps the company earns enough on this amount to pay back the ratable portion for each year while keeping the amount of the benefit as a permanent fund on which no interest or dividend will ever be paid. Some states adopted normalization even before the 1971 amendments,[214] but since then almost all states have switched to one of these two options.[215]

There is a third option allowing flow-through for that limited group of assets described in section 167(*l*)(2)(c), post-1969 assets of a type on which flow-through of accelerated depreciation benefits was allowed immediately prior to 1970.[216] Lest there be too

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212. Such depreciation would reduce the rate base. The regulations are not clear on this, however. *See* Treas. Reg. § 1.46-5(c)(3)(1972).

213. I.R.C. § 46(f)(2). The Treasury Department recognizes the windfall presently given utility investors by § 46(f), and has proposed the elimination of § 46(f)(2) along with the amendment of § 46(f)(1) to remove the restoration to rate base. The result would be that rate base would be permanently reduced by the amount of the credit for both depreciation and rate of return purposes. *Continued Hearings on Tax Expenditures Focusing on Utility Companies Tax Treatment: Hearings Before Subcommittee on Oversight, House Ways and Means Comm.*, 96th Cong., 1st Sess. 1979 (March 28, 1979 Statement of Emil M. Sunley) (unpublished to date).

214. *E.g.*, Inter-mountain Tel. Co., 59 PUB. U. REP. 3d (PUR) 337, 342-43 (Tenn. P.S.C. 1965) (allowing full normalization); Accounting Procedure for Investment Tax Credit, 78 PUB. U. REP. 3d (PUR) 167, 187 (Fla. P.S.C. 1969).

215. Only one jurisdiction out of 56 was still requiring flow-through of investment tax credit by 1976, according to the NARUC Report, *supra* note 80, at 505. The Andersen Co. study, *supra* note 80, shows 5 jurisdictions still flowing-through investment tax credit. In addition, some commission orders seem to ignore the 1971 amendment by deducting the deferred taxes from rate base without mention of any ratable restoration. *E.g.*, Mountain States Tel. & Tel. Co., 8 PUB. U. REP. 4th (PUR) 547, 550 (Ariz. Corp. Comm'n 1975); Northwestern Bell Tel. Co., 8 PUB. U. REP. 4th (PUR) 75, 80 (Minn. P.S.C. 1974); Northwestern Bell Tel. Co., 15 PUB. U. REP. 4th (PUR) 289, 295 (S.D.P.U.C. 1976).

216. I.R.C. § 46(f)(3). See note 74 and accompanying text *supra*. At least one company is still apparently on option 3. Washington Utils. and Transp. Comm'n v. Pacific Power & Light, 10 PUB. U. REP. 4th (PUR) 449, 455 (Wash. Util. & Transp. Comm'n 1975);

much flow-through, however, Congress has further limited this option by providing, in a wonderful example of Internal Revenue Code linguistics, that any such election should apply only to the credit "determinable as if the Tax Reduction Act of 1975 and the Tax Reform Act of 1976 had not been enacted."[217] Presumably this means a company can only get up to a four percent investment tax credit if it is so unworldly as to elect option three.[218]

Finally, IRC section 46(a)(2)(B)(i) provides for an extra one percent of investment tax credit for money paid out by the company to purchase its own stock on behalf of its employees.[219] IRC section 46(f)(9) denies any extra credit under this last section if cost of service is reduced by the credit for ratemaking, if the rate base is reduced for ratemaking, or if any part of the credit is treated in any way "other than as though it had been contributed by the taxpayer's common shareholders."[220] Thus the Internal Revenue Code specifically requires the payment of the ratepayers' money rather than stockholders' money for the purpose of buying corporate stock for the companies' employees. In this instance, the prohibition is not only against ratable flow-through or reduction of the rate base, but also against reduction of the cost of service or the rate base at any time. In short, the so-called tax benefit is available only if charged fully to the ratepayers as

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Washington Util. & Transp. Comm'n v. Pacific Power & Light, 7 PUB. U. REP. 4th (PUR) 470, 487 (Wash. Util. Transp. Comm'n 1974). *But see* I.R.S. ruling, Nov. 22, 1976, regarding Southern Cal. Gas Co., No. 85627 (Cal. P.U.C. 1976), and Southern Cal. Gas Co., No. 86118 (Cal. P.U.C. 1977), *aff'd sub nom.* Southern Cal. Gas Co. v. Pub. Utils. Comm'n, 23 Cal. 3d 470, 591 P.2d 34, 153 Cal. Rptr. 10 (1979) (denying investment tax credit, where a company with property eligible for option 3 declined to exercise it and exercised option 2 instead, and the California Commission lowered its rate of return by .25% to take account of the reduced risk). The California Supreme Court held specifically that reduction in rate of return was not bound by §§ 46(f)(2) or (8), but that if tax credit was later denied the company could then petition the commission for appropriate relief. Southern Cal. Gas Co. v. Pub. Utils. Comm'n, 591 P.2d 34, 42-43, 153 Cal. Rptr. 10, 18-20 (1979). The company has petitioned for rehearing. Doc. No. SF-23495.

217. I.R.C. § 46(f)(8). This subsection is replete with other options the general effect of which is to require the companies to make new elections to continue option 3. *See also* Temp. Reg. § 9.1(c)(2) (requiring a company to recite that any option 3 election is a voluntary act not imposed by any agency). As to how the first 4% of tax credit is distributed when a company has some option 3 property and other option 1 or 2 property, see Temp. Reg. § 9.1(a)(3).

218. *But see* Temp. Reg. § 9.1(a)(2) indicating that other increases in the amount of benefits available are also to be denied, without mentioning possible decreases.

219. The credit can be extended another ½% simply by having the employees contribute toward the stock purchase an additional sum equal to this amount, which can be easily reimbursed in extra salaries. I.R.C. § 46(a)(2)(B)(ii).

220. The employer contributions are not deductible. *See* Proposed Reg. § 1.46-8.

though there were no benefit and if the company can also earn a full return on the benefit as if it had been actually contributed by the shareholders.

The California Public Utilities Commission has tried to soften the effects of normalization. While complying with the second option by allowing normalization with no reduction of the rate base and ratable flow-through of the credit, it ordered that the ratable amount of investment tax credit to be flowed through should be subject to an annual adjustment to reflect growth in the total investment tax credit based on the most recent estimate of eligible plant additions to be added in the next year. Thus, if there is an estimated growth in investment tax credit each year, there will be a larger share subject to ratable flow-through, reducing the revenue requirement to some extent.[221]

As with the part of the California decision on annual adjustments for growth in accumulated deferred taxes from accelerated depreciation,[222] the Internal Revenue Service has issued an adverse ruling, although in this case the ruling is more understandable.[223] The crux of the opinion letter is simply that by including the adjustment to the ratable portion of the credit based on estimated growth of investments in new property without including an adjustment to the rate base to reflect such growth, the rate base would be considered reduced in violation of section 46(f)(2)(B).[224] Similarly, approaching the question from the position of option one, the letter ruling states that the failure to adjust the rate base on the basis of the new investment implies no increase in annual depreciation expense reflective of the increase in depreciation base from the projected new investment, which is viewed by the IRS as reducing the cost of service in violation of section 46(f)(2)(A).[225]

The ruling exhibits two flaws. First, it seems to assume that every increase in investment would increase the rate base, while it is possible, indeed likely, that much of the new investment expense allowed as proper for investment tax credit purposes would not go into the rate base until completion of a new plant,

221. Pacific Tel. & Tel., No. 87838, Slip. op. at 29 (Cal. P.U.C., filed Oct. 13, 1978). See note 88 *supra*. Appeal and further litigation has so far upheld the commission decision. See notes 100-102 *supra*.

222. See note 96 and accompanying text *supra*.

223. Letter of July 27, 1978, from John W. Holt, Director, Corporation Tax Division, to Robert Dalenberg, Vice-President and General Counsel, Pacific Tel. & Tel.

224. *Id.*

225. *Id.*

possibly a period of ten or more years.[226] Second, it strains the language to say that a mere failure to project the rate base upward results in a reduction of the rate base or of annual depreciation expense. Traditionally, the regulatory agencies are allowed some degree of discretion in making *pro forma* adjustments, or adjustment of test year data for known or reasonably calculable and more current variations.[227] This clause is less objectionable than the adjustment clause dealing with accelerated depreciation benefits approved by the California commission because the effect on related items is not as demonstrable.[228] The commission ruling was affirmed by denial of review, and the companies have failed, so far, in their effort to enjoin enforcement of the commission order.[229] The tangle once again suggests that Congress reconsider either its entire policy of granting incentive tax benefits to regulated companies or its policy requiring normalization. The California commission suggested that Congress resolve the difference by enacting a gross receipts or unit consumption tax for utilities instead of the income tax.[230]

V. Legal Infirmities of Normalization

A. *The Statutory and Constitutional Duty to Set Just and Reasonable Rates*

Up to this point, the primary thrust of this article has been to show that the practice of including fictitious taxes in current rates and deferring the tax benefits until later years is unwise, unfair to current ratepayers, and unduly generous to future ratepayers who receive the benefits of the tax monies collected from today's ratepayers. Arguments have been advanced that regulatory commissions should not allow normalization by rule or by ratemaking decisions and that Congress should reconsider and repeal the legislation that has favored its allowance.[231] This section examines whether the allowance of fictitious taxes is lawful under the traditional statutory and constitutional standards of ratemaking.

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226. See note 203 *supra* (regarding the allowance of progress payments on long-term construction to be included for investment tax credit).

227. See note 142 and accompanying text *supra*.

228. See note 95 *supra* (concerning adjustment clauses).

229. See notes 100-102 *supra* concerning review of this order.

230. *See* Pacific Tel. & Tel., No. 87838, Slip op. at 46 (Cal. P.U.C., filed Oct. 13, 1978).

231. I.R.C. §§ 167(*l*), 46(f).

If a regulatory agency is performing its duty, it must set rates designed to secure a reasonable return to the regulated company.[232] By adding the amount of a fictitious expense, a regulatory agency is granting more than a reasonable return.[233] If the agency allows the expense but reduces the rate of return to compensate for the windfall, it simply commits a second wrong by not allowing the proper rate of return.[234] This type of evasion results in a virtually unreviewable order, because there is not a proper finding as to either cost of service or rate of return.[235]

Almost all utility regulatory bodies are authorized to establish maximum rates which are "just and reasonable."[236] Arguably, in setting such rates the commission is engaged in a "legislative" activity that may not be reviewed by a court. The courts have routinely reviewed rate cases, however, and generally statutes in most jurisdictions require review at least to determine if the order is lawful, within the agency's jurisdiction and discretion, reasonable, not arbitrary and capricious, and supported by the evidence.[237] Although statutory language of this kind does not pro-

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232. *E.g.*, Smyth v. Ames, 169 U.S. 466, 547 (1898). See also note 22 *supra*, for typical statutes requiring a reasonable return.

233. *See* Acker v. United States, 298 U.S. 426, 429 (1936) (affirming disallowance of fictitious salary expense). Galveston Elec. Co. v. City of Galveston, 258 U.S. 388 (1922) (disallowance of hypothetical broker's fees approved where under existing practice it could not be shown as a real expense). In Edison Light & Power Co. v. Driscoll, 25 F. Supp. 192 (E.D. Pa. 1938), the court stated that

> the rights of both the public and the corporation must be considered. The company is entitled to a fair return on a fair value of its property devoted to the public service. The return can not be so high as to exceed the value of the service to the consumer and can not be so low as to confiscate the property devoted to that service. In other words the company is entitled to ask a fair return upon the value of the property which it employs for the public convenience and the public is entitled to demand that no more be exacted from it than the services rendered are reasonably worth.

Id. at 193; *accord,* Lakewood Water & Power Co., 21 PUB. U. REP. 3d (PUR) 103 (Cal. P.U.C. 1957) (All charges made by a utility against its ratepayers must be reasonable and it is the duty of the commission to prevent a utility from passing on to ratepayers unreasonable costs of materials or services).

234. The agency may also be engaging in a subterfuge prohibited by congressional requirement of normalization. *See* note 231 *supra.*

235. New England Tel. & Tel. Co., 115 Vt. 494, 498, 66 A.2d 135, 138 (1949) (reversing for lack of adequate findings a commission order that failed to establish a proper rate base and allowable expenses).

236. *E.g.*, Natural Gas Act, §§ 4-5 15 U.S.C. §§ 717(c) - (d) (1976). State statutes have similar provisions. *See* note 22 *supra.*

237. *See* Administrative Procedure Act, 5 U.S.C. § 706 (1976); MO. REV. STAT. § 536.140 (Vernon Supp. 1978); WIS. STAT. ANN. § 227.20 (West Supp. 1978). The Supreme Court has held the determination of just and reasonable rates to be a quasi-judicial act.

vide complete guidance, some generalizations are possible. The substantial evidence rule is leading away from judicial reversals of administrative determinations of factual issues.[238] When the question is the legal interpretation of a statutory requirement, however, the courts will and should intervene even if a policy issue is involved.[239] Language in some of the opinions indicates that the question of normalization is a policy decision that should be left to the agencies,[240] but these are generally self-serving conclusions designed to strengthen the argument in favor of a particular result.

The question of whether current ratepayers can be charged for future or fictitious taxes must be resolved as a legal question to preserve any legal review of rates. If fictitious charges can be included in rates, the agencies are free from any control; any legally allowable return could be supplemented by adding fictitious costs and the courts would be powerless to intervene to enforce the legislative requirement of just and reasonable rates. The legality of rates, however, has long been considered an appropriate subject for court determination. Most attention has focused on review requested by the utilities, and there are well-established statutory and constitutional duties to provide a regulated utility with a fair return on its property devoted to public service.[241]

Morgan v. United States, 298 U.S. 468 (1936). *But see* United States v. Florida East Coast Ry. Co., 410 U.S. 224 (1973) (allowing ratemaking without an adminimistrative hearing where the case did not involve a set of disputed facts).

238. 1 A. PRIEST, *supra* note 42, at 438-39. At one time it was held that due process required the opportunity for a reviewing court to determine both law and facts independently where confiscation was claimed. *See, e.g.,* Ohio Valley Water Co. v. Ben Avon Borough, 253 U.S. 287, 289 (1920).

239. NLRB v. Brown, 380 U.S. 278 (1965); Schaffer Transp. Co. v. United States, 355 U.S. 83 (1957); Federal Power Comm'n v. Pacific Power & Light Co., 307 U.S. 156 (1939); Huntley v. Public Utils. Comm'n, 69 Cal. 2d 67, 442 P.2d 685, 69 Cal. Rptr. 605 (1968); W.S. Hatch Co. v. Public Serv. Comm'n, 3 Utah 2d 7, 10, 277 P.2d 809, 811 (1954).

240. *See* Order 530B, *supra* note 180; Alabama-Tennessee Natural Gas Co. v. Fed. Power Comm'n, 359 F.2d 318, 335-36 (5th Cir. 1966) (approving FPC shift from normalization to flow-through, and adopting view of Solicitor General expressed in opposition to grant of certiorari in El Paso Natural Gas Co. v. Federal Power Comm'n, 281 F.2d 567 (5th Cir. 1960), *cert. denied,* California v. Federal Power Comm'n, 366 U.S. 912 (1961), that no general issue of law was involved, but merely a discretionary choice between accounting systems).

241. The state may not, under the guise of regulating rates, require a utility to serve the public without reward or do that which amounts to a taking of private property for public use without just compensation. Railroad Comm'n Cases, 116 U.S. 307, 331 (1886). Such deprivation is a denial of due process and equal protection. Smyth v. Ames, 169 U.S. 466, 523-24 (1898).

This duty is made clear by a long line of Supreme Court opinions addressing the question of what value to place on a utility's property. In *Smyth v. Ames,*[242] the Court held that for the company to receive the just compensation to which it was entitled, it must earn a proper return based on the fair value of the property dedicated to public service, considering the original cost, costs of improvements, the market value of its securities, present reproduction costs, and the probable earning capacity of the property.

In *Southwestern Bell Telephone Co. v. Public Service Commission,* decided during a period of considerable inflation, the majority held that the present cost of replacement was a most important element of value.[243] Justice Brandeis, in his concurrence, suggested that the proper measure of value was the actual capital prudently invested by the company.[244] For present purposes it is only necessary to note that all views recognized a constitutional obligation to grant a fair return.

Subsequently, in a line of cases culminating with *Federal Power Commission v. Hope Natural Gas,*[245] the Supreme Court ostensibly escaped the rate base valuation quandary by holding that the Commission need only set rates which enable the company to operate successfully, to maintain its financial integrity, and to attract capital by providing a return commensurate with return on investments having corresponding risks.[246] The Court used language indicating that the reviewing courts should not be as concerned with theory or the method of setting the revenue requirement as with assuring that the overall effect or impact is reasonable.[247] *Hope* presented a question of statutory review of the reasonableness of rates for interstate sales of gas set by the Federal Power Commission. The case did not hold that constitutional limits had been ended, but merely that they were not greater than the statutory limits.[248] *Hope* has been perceived by state courts and commissions as setting constitutional standards.[249] However,

242. 169 U.S. 466, 546-47 (1898).
243. 262 U.S. 276, 288 (1923).
244. *Id.* at 310.
245. 320 U.S. 591 (1944).
246. *Id.* at 605-07.
247. *Id.* at 602.
248. *Id.* at 607.
249. United Gas Pipe Line Co., 34 PUB. U. REP. 3d (PUR) 78, 89 (La. P.S.C. 1960); New England Tel. & Tel. Co. v. New Hampshire, 104 N.H. 229, 232, 183 A.2d 237, 240 (1962); Narrangansett Elec. Co. v. Kennelly, 88 R.I. 56, 71, 143 A.2d 709, 718 (1958).

Hope, together with the *Permian Basin Area Rate Cases,*[250] may be read as erasing the constitutional protection of the utility investor.[251] The Court's opinion in *Hope* does not specifically end the duty to the investor, but rather redefines the standards for evaluating performance of that duty. The old standards, based on trying to properly define the value of utility property, are replaced with a still more elusive set of guidelines, based on predicting the rate of return that will maintain confidence in the company's financial integrity and attract the necessary capital to adequately serve the customers.[252]

In the *Permian Basin Area Rate Cases,*[253] the Court allowed the setting of natural gas prices on a producing-area basis, ap-

250. 390 U.S. 747 (1968).

251. Bernstein, *Utility Rate Regulation: The Little Locomotive That Couldn't,* 1970 WASH. U.L.Q. 223, 260.

252. 320 U.S. at 605. For a contemporary state court explanation of this duty, see New England Tel. & Tel. Co. v. Public Utils. Comm'n, 390 A.2d 8, 14, 15, 30-39 (Me. 1978).

The regulatory industry has attempted to meet these standards in a number of ways. The most common method used is discounted cash flow, in which a group of comparable utility companies is picked by descriptive qualities (such as size, mix of service furnished, etc.) and then compared to the first for which rates are being set in terms of growth of both dividend yield and book or market value over a period of time. There is considerable disagreement concerning how these comparisons should be made. See C. PHILLIPS, THE ECONOMICS OF REGULATION 284-88 (1969); P. GARFIELD & W. LOVEJOY, PUBLIC UTILITY ECONOMICS 125-34 (1964).

A second method is based on the capital asset pricing model. See Sharp, *Capital Assets Prices: A Theory of Market Equilibrium under Conditions of Risk,* 19 J. OF FINANCE 425 (1964). The technique was developed for general investment purposes. As applied to utility rates the method uses a number of data readings for a large group of firms including nonutilities over a reasonably long period of time (usually at least 60 months) to identify firms of comparable risk to the utility in question in terms of demonstrated similarity in market behavior. A recommended rate of return on equity is derived by an averaging method applied to the returns earned by these "comparable" firms.

A third method, stochastic dominance, uses a similar data base but derives the comparison group by means of comparing the company in question with other companies in terms of their "dominance" or preferability to an imaginary "risk averse" investor, disguised as a computer, who wants to earn a return with as little risk as possible. See Porter & Gaumnitz, *Stochastic Dominance v. Mean-Variance Portfolio Analysis: An Empirical Evaluation,* 62 AM. ECON. REV. 438 (1972).

Unfortunately, utility common stock prices may relate to different factors at different times. At present, they seem to relate most closely to utility bond prices and the general interest rate. If one could predict with accuracy what tomorrow's investors will do there would be no problem. It is doubtful, however, whether a person or even a computer can perform this magic with complete success in the long run. On the other hand few utility companies have folded in the years since the Bluefield-Hope formulation has been in force. Perhaps the vagueness of the formula itself has assured the investment community that the commissions will over the long run have to grant a reasonable return.

253. 390 U.S. 747 (1968).

proving possible different rates for each producing area. This method seems to depart substantially from the concept of a return on rate base, and the Court's opinion states that the investor interest is only one of the calculable interests, and a return on investment can be stringently limited.[254] Nevertheless, the opinion falls short of totally abandoning review of the substantive reasonableness of rates. In the first place the setting of rates for gas producers by the Federal Power Commission and the setting of electric, telephone or retail gas rates at a local level is not analogous; the former deals with a competitive situation and the later with a monopolistic one.

In concluding that *Permian* "abandons even the limited scope of review of the substantive reasonableness of rates that it retained in *Hope,*" Professor Bernstein emphasizes that language in the opinion stating that the court should not supplant the commission's balance of interests with one more to its liking, but should merely assure itself that the commission has given reasoned consideration to each of the pertinent factors.[255] In the same paragraph, however, the Court stated that the reviewing court must determine if the commission abused its discretion or exceeded its authority, examine the manner in which the Commission employed the methods of regulation selected and decide whether each essential element of the order is supported by substantial evidence, and determine whether the order may reasonably be expected to maintain financial intergrity, attract necessary capital, fairly compensate investors for their risk and yet provide appropriate protection to the relevant public interests, existing and foreseeable.[256] Thus *Permian* specifically repeats the *Hope* requirements. Financial integrity cannot be maintained nor capital attracted without allowing a fair return on capital. Particularly with a regulated utility, yield is the factor investors look at first. Although the quibbling about the rate base definition may be over, the regulation of returns still entails due process considerations. Indeed, the reasonability of the revenue return is so interwoven and so central to the outcome of utility regulation that it cannot be freed from court review unless the whole ratemaking process is placed beyond review.

The courts have not indicated a willingness to surrender the

254. *Id.* at 796-800.
255. Bernstein, *supra* note 251 at 258 (quoting 390 U.S. at 791-92).
256. 390 U.S. at 792.

power to review the reasonability of the revenue return.[257] Neither the companies nor the consumers have mounted any recent attack on review. The post-1935 Supreme Court has not held rates to be confiscatory as frequently as in the past, and perhaps other courts have learned that their own judgments on this issue are not beyond challenge.[258] An equally important factor is that the commissions have learned the lesson of *Hope* so well that they do not often come close to setting confiscatory rates. In addition, some commissions have perhaps learned to hide their conclusions in terms of the exercise of discretion.[259] Unless a commission is honest and articulate about what it is doing, however, review is impossible. This is precisely why *Permian* tells us that

> [j]udicial review of the Commission's orders will therefore function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which it has chosen to act, as well as its assessment of the consequences of its orders for the character and future development of the industry.[260]

The emphasis on consistency of a commission's actions with its own selected method of setting rates suggests that normalization is well within the area left for judicial review. Present day courts will not frequently set aside a commission order on revenue requirements because of an insufficient rate of return without positive evidence that the rate will actually produce a dangerous

257. *See* Panhandle E. Pipe Line Co. v. Federal Power Comm'n, 324 U.S. 635, 651 (1945), affirming an order in which the Court was unable to say that on evidence the return was not commensurate with the risk, that investor confidence was impaired or that company ability to attract capital and to operate successfully had been impeded. The state commissions and courts have continued to exercise their power to prevent confiscation under the due process clause. *E.g.,* New England Tel. & Tel. Co. v. Department of Pub. Utils., 327 Mass. 81, 94-95, 97 N.E.2d 509, 516-17 (1951); City of Scottsbluff v. United Tel. Co., 31 PUB. U. REP. 3d (PUR) 446, 450 (Neb. St. Ry. Comm'n 1959) (municipal tax held confiscatory in absence of commission authorization for tax to be passed on to customers within the municipality, since increasing company's expenses reduces its rate of return).

258. *See* New Jersey Power and Light Co., 9 N.J. 498, 89 A.2d 26 (1952) (dictum) (due process is violated only when the rate base determination, allowances of income and operating expense and rate of return are illegally arrived at or not determined at all); New England Tel. & Tel. Co. v. Department of Pub. Utils., 327 Mass. 81, 97-98, 97 N.E.2d 509, 518 (1951).

259. For instance, if there is evidence to support a range of rate of return on equity between 9% and 16% the commission can afford to give in to the company's argument for normalization but allow a rate of return closer to the 9% figure without running any serious risk of reversal on the rate of return issue.

260. 390 U.S. at 792.

effect on the company's ability to raise needed capital. On the other hand, when rates are set including a fictitious expense in addition to a fair rate of return, the decision must be considered arbitrary and can be set aside to the same extent as if a commission arbitrarily ignored an actual expense. The courts must resolve the legal question whether the allowance of a fictitious expense is consistent with ratemaking in its present form.[261] The broad discretion exercised by regulatory commissions concerning the proper rate of return itself requires that close attention be given to cost of service and rate base items in order to preserve any legal control over the system.[262]

The cases dealing with the existence of a constitutional duty to the utility company have been reviewed because it is in this area that most of the litigation has occurred. Until recent years, appeals by the consumer were rare. There are fewer cases explicating the constitutional duty to the ratepayers. Such a duty, however, has been recognized from the beginning. "The question of reasonability of a rate . . . , involving as it does the element of reasonableness both as regards the company and as regards the public is eminently a question for judicial investigation, requiring due process of law for its determination."[263]

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261. Justice Jackson, concurring in Federal Power Comm'n v. Hope Natural Gas, 320 U.S. 591 (1944), observed that if the Court is to hold a rate reasonable merely because the commission says it is reasonable, review itself "becomes a costly time-consuming pageant of no practical value to anyone." *Id.* at 645.

262. West Ohio Gas Co. v. Public Util. Comm'n of Ohio, 294 U.S. 63, 70-76 (1935) (reversing state court affirmance of commission order that improperly disallowed various expenses without evidence of negligence or impropriety on part of the company incurring them); Lincoln Gas & Elec. Light Co. v. City of Lincoln, 250 U.S. 256, 267-68 (1919) (finding error in allowance of unpaid taxes and too liberal allowance for working capital and other expenses sufficient to offset an otherwise confiscatory rate of return); Chicago & Grand Trunk Ry. v. Wellman, 143 U.S. 339 (1892) (affirming rates as nonconfiscatory in the absence of full record demonstating that company had not managed to "transfer its earnings into what it is pleased to call 'operating expenses' " *Id.* at 345-46); Arkansas-Louisiana Gas Co. v. City of Texarkana, 96 F.2d 179, 187 (8th Cir. 1938) (affirming disallowance of expense due to gas leakage in excess of a reasonable allowance); San Diego Water Co. v. City of San Diego, 118 Cal. 556, 572, 50 P. 633, 638 (1897) (all expenses must be shown to be actual and property charges); Westwood Lake, Inc. v. Metropolitan Dade County Water and Sewer Bd., 203 So. 2d 363, 365-66 (Fla. App. 1967) (reversing order reducing executive compensation); Davenport Water Co. v. Iowa St. Comm. Comm'n, 190 N.W.2d 583, 607-09 (Iowa 1971) (affirming disallowance of charitable contribution, but reversing because of use of improper formula to reduce property tax allowance); New England Tel. & Tel. Co. v. Department of Pub. Utils., 360 Mass. 443, 484-92, 275 N.E.2d 493, 518-22 (1971) (reversing because of commission failure to allow charitable contributions and contractual wage increases).

263. Chicago, Mil. & St. P. Ry. v. Minnesota, 134 U.S. 418, 458 (1890); *accord,* Smyth v. Ames, 169 U.S. 466, 544, 547 (1898) (stating that the fair value principle was required

The duty to protect the public against gouging by the owners of monopolies is actually the basis of regulation,[264] and the duty to avoid confiscatory rates merely acts as a check on that regulatory power. Review on the side of the company would be difficult to justify without review on the side of the public. The right of a utility to charge unlimited rates and a commission approval of an unreasonably high return would of course, if exercised, be in itself a confiscation of the property of its industrial and commercial customers that would deprive them of the opportunity to employ that property in a profitable manner. Indeed, even if there was conceded to be no further due process duty to the companies (which, after all, are able to close their plants and go out of business), there is still a duty to the public who is entitled to receive the necessary services at just and reasonable prices.[265]

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to protect the public from overcharge as well as to protect the company from undercharge). *See also* Federal Power Comm'n v. Natural Gas Pipeline Co., 315 U.S. 575, 585-86 (1942) (indicating that the constitutional and statutory "reasonability" standards for minimum rates are the same and adopting the notion that there is a zone of reasonableness above the lowest nonconfiscatory rate in which rates are constitutionally allowable, thus implying a constitutional ceiling to this zone). *See* Georgia Power Co. v. Georgia Pub. Serv. Comm'n, 231 Ga. 339, 201 S.E.2d 423 (1973).

264. Munn v. Illinois, 94 U.S. 113 (1876).

265. Edison Light & Power Co. v. Driscoll, 25 F. Supp. 192 (E.D. Pa. 1938); Wood v. Public Util. Comm'n, 4 Cal. 3d 288, 481 P.2d 823, 93 Cal. Rptr. 455 (1971) (rejecting on the merits equal protection claim against credit rules adopted by the commission); State *ex rel.* Electric Co. v. Atkinson, 275 Mo. 325, 337, 204 S.W. 897, 899 (1918) (in upholding issuance of certificate of convenience and necessity to a competing company where the licensed firm was gouging, the court stated, "The spirit of this [regulatory] policy is the protection of the public. The protection given the utility is incidental."); New England Tel. & Tel. Co., 85 PUB. U. REP. (NS) (PUR) 232 (N.H.P.S.C. 1950); Virginia v. Virginia Elec. and Power Co., 211 Va. 758, 180 S.E.2d 675 (1971) (rates fixed by the commission should be just and reasonable to the consumers as well as to the utility). *Contra*, City of Birmingham v. Southern Bell Tel. and Tel. Co., 234 Ala. 526, 533, 176 So. 301, 306 (1937); Brooklyn Union Gas Co. v. City of New York, 50 Misc. 450, 100 N.Y.S. 570 (1906) (denying to the city, on behalf of the public, the right to inspect a utility company's books, and stating that the customer has no constitutional right to a reasonable price, because he is not under an obligation to purchase gas). *See* St. Paul Book & Stationery Co. v. St. Paul Gaslight Co., 130 Minn. 71, 153 N.W. 262 (1915) (holding that exorbitant prices amount to an enforced taking of whatever the consumer pays in excess of a reasonable charge, but denying injunctive relief where a suit for damages or appeal of the administrative order were available remedies).

The existence of a duty to ratepayers has been discussed in several recent notes and comments as a question of whether there is a protected property interest on the part of the ratepayer under the fourteenth amendment. Note, *Due Process Restraint on the Use of Automatic Adjustment Clauses in Utility Rate Schedules,* 18 ARIZ. L. REV. 453 (1976); Note, *Due Process and the Automatic Fuel Adjustment Clause,* 52 IND. L.J. 637 (1977); Note, *Due Process: Applicability to Utility Rates, State ex rel. Jackson County v. Public Serv. Comm'n* 42 MO. L. REV. 152 (1977). These discussions and the cases therein dis-

The numerous cases developing the rule that allows only the actual company taxes to be charged to the ratepayer are based on the legal duty to provide just rates and the principle that the allowance of fictitious expenses is unlawful. Without going so far as to say that the consumer always has a constitutionally protected property interest in just and reasonable rates, the proposition that they do not have such an interest when it comes to the matter of normalization of taxes is certainly easy to reject. The effect and apparent intention of the normalization method is to make the customer involuntarily into an investor, at least temporarily.[266] If the stockholder who chooses to invest in a utility has a constitutional right to a reasonable return on his money, how can there not be a constitutional right of the ratepayer either to a similar return on his money invested by operation of law or a right to withhold such investment? The allowance of normalization in every instance gives the utility company and the investor the right to use the ratepayers' dollars without the allowance of a return. Surely the ratepayers' rights in this instance are as great as the rights of the voluntary investor.

In summary, rates set to include recovery of fictitious taxes clearly violate the statutory duties to set just and reasonable

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cussed relate to procedural due process rights of the ratepayer to a hearing in various situations, such as the use of automatic escalator clauses based on fuel prices, City of Chicago v. Illinois Comm. Comm'n, 13 Ill. 2d 607, 150 N.E.2d 776 (1958); City of Norfolk v. Virginia Elec. & Power Co., 197 Va. 505, 90 S.E.2d 140 (1955); the allowance of rate increases (usually temporary) without a prior hearing, Hartford Consumer Activist Ass'n v. Hausman, 381 F. Supp. 1275 (D. Conn. 1974); Sellers v. Iowa Power & Light Co., 372 F. Supp. 1169 (S.D. Iowa 1974); Holt v. Yonce, 370 F. Supp. 374 (D.S.C. 1973), *aff'd mem.*, 415 U.S. 969 (1974); State *ex rel.* Jackson County v. Public Serv. Comm'n, 532 S.W.2d 20 (Mo. 1976); and the adoption of credit rules without a prior hearing, Wood v. Public Utils. Comm'n, 4 Cal. 3d 288, 481 Pa. 2d 823, 93 Cal. Rptr. 455 (1971).

All of these cases involve "procedural" due process in the narrow sense that the question considered was the adequacy of the procedures carried out. Such issues are not likely to arise with respect to the matters discussed in this article, as ultimately all interested parties are usually allowed to participate in rate hearings and the results are required by law to be based on substantial evidence.

The constitutional review of rate orders concerning arbitrariness or unreasonability is frequently called procedural due process because of the fiction that the commissioners could not have followed due process if their order is unreasonable. This standard of review is more accurately described by the older name, substantive due process. Whether one calls it procedural or substantive, however, there simply has been no case holding directly or indirectly that the basic issue of the reasonability of revenue allowed to be recovered by a utility is not subject to review under constitutional standards.

266. Davenport Water Co., 76 PUB. U. REP. 3d (PUR) 209, 237 (Iowa St. Comm. Comm'n 1968); New England Tel. & Tel. Co., 13 PUB. U. REP. 4th (PUR) 65, 85 (Me. P.U.C. 1976) (quoting Central Me. Power Co., 17 PUB. U. REP. 3d (PUR) 452 (Me. P.U.C. 1957)).

rates. The courts have consistently held that there are corresponding constitutional duties and that the state commissions may not legally set such rates under any of the applicable standards. Because of the constitutional limits set by the Supreme Court, the congressional requirement of normalization must be invalid to the extent that it conflicts with such limits.

B. Abuse of the Taxing Power

Prior to the formulation of normalization, the general rule in setting rates was that income taxes were considered an operating expense to be recovered as a cost of service.[267] On this basis, revenue requirement is computed by allowing the company to recover its "actual" income taxes.[268]

The "actual taxes" rule has frequently been applied to prevent normalization,[269] and normalization has been allowed primarily as the result of congressional tax laws which in effect have converted or extended tax code business stimuli into forced ratepayer advances. The tax benefit is not given unless the ratepayers pay an equivalent amount.[270] The tax law is thus being used solely for regulatory purposes.

Although Congress may have the power to regulate intrastate rates,[271] even under the commerce power there would be some limit to this authority. In *Heart of Atlanta Motel, Inc. v. United States,* the Court indicated that Congress must have a rational basis for concluding that the prohibited activity affects intrastate commerce, and that the means chosen to achieve the desired result must be reasonable and appropriate.[272] A more important limitation on the commerce power for purposes of this discussion

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267. Note 141 *supra.*

268. Note 142 *supra.*

269. Niagara Mohawk Power Corp., 28 PUB. U. REP. 3d (PUR) 171, 192-94 (N.Y.P.S.C. 1959); City of Pittsburgh v. Public Util. Comm'n, 182 Pa. Super. 551, 128 A.2d 372, 385 (1956); United Fuel Gas Co., 46 PUB. U. REP. 3d (PUR) 118, 128 (W. Va. P.S.C. 1962). *See also* cases cited in note 52 *supra.*

270. See Part II.B. and Part IV *supra.*

271. *See* Railroad Comm'n of Wis. v. Chicago B. & O. R.R., 257 U.S. 563 (1922) (allowing congressional regulation of intrastate railroad rates). Electricity does not move through states carrying other goods as do railroads, and federal regulation might have to be based upon the indirect effects of intrastate electric rates on interstate commerce. *See* Wickard v. Filburn, 317 U.S. 111 (1942) (allowing congressional regulation of farm production for intrastate sales and home use). Because of distribution line loss electricity does not have a truly national market as does wheat, but it can easily be distributed across state lines.

272. 379 U.S. 241, 258-59, 62 (1964).

is the tenth amendment preservation of the governmental power of the states. In *National League of Cities v. Usery*, the Court invalidated federal legislation requiring state compliance with the Fair Labor Standards Act.[273] This commerce power legislation was intended to assure wage parity between state employees and most federal and private employees on a uniform national basis. By contrast, the federal purpose for normalization is very weak, and the imposition on state government is much greater. The states, which are charged with the responsibility for setting just utility rates and which have regulatory commissions which are legally and politically held responsible for this task, are required to severely alter their normal ratemaking practices in favor of the regulated companies. An unreasonable complication is raised in carrying out an already difficult and complex state governmental operation.

Arguably, Congress cannot force states to regulate in accordance with federal requirements, even when the regulations themselves might be valid under the commerce power were they to be enforced directly by the federal government. The intrusion on state government is too great and violates the tenth amendment when less intrusive means are available.[274] There is great doubt whether this type of federal legislation could be sustained under the commerce power. The utility income tax normalization may not affect commerce, because the utilities are required to meet the demand for service by building adequate power generating facilities even without the benefit of federal subsidies. If the subsidies are not sustainable, their normalization would fail for the same reason. Moreover, conceding that Congress might reasonably under the commerce power subsidize utility construction by tax relief, normalization may not be a reasonable means to accomplish this because the interference with state ratemaking is out of proportion to the subsidization purpose.

This point has been developed to show the limitations on Congress created by the commerce clause, under which congressional interference with state activities has been most frequently tested and most broadly expanded. In this instance, however,

273. 426 U.S. 833, 852 (1976).

274. District of Columbia v. Train, 521 F.2d 971, 992-94 (D.C. Cir. 1975). *See also* Brown v. EPA, 1521 F.2d 827, 831 (9th Cir. 1975); Maryland v. EPA, 530 F.2d 215, 225 (4th Cir. 1975). On appeal of these cases the Supreme Court denied review because the federal government conceded that it could not require the states to promulgate the regulations in question. EPA v. Brown, 431 U.S. 99 (1977) (per curiam).

Congress has not purported to protect the flow of interstate commerce,[275] but has simply exercised the taxing power to require certain state regulatory practices and results. This is not a case in which a taxing penalty is used to aid in a scheme designed to regulate commerce.[276] Congress has not articulated or achieved any recognizable goal relating to the flow of commerce by this legislation.

Setting aside the commerce clause, the legislation requiring normalization is also questionable when considered simply as a taxing measure. Modern cases have tended to uphold federal taxing statutes when their primary purpose is to regulate questionable activities such as firearms sales, drug transactions and bookmaking.[277] In each instance, however, the Court has noted that the tax produced revenue and therefore was supported by the taxing power.[278] There is no case upholding a regulatory tax statute which does not produce some tax revenue. In *Minor v. United States,*[279] the Court sustained convictions under a taxing statute making it illegal to sell heroin except upon an official order blank, which was in fact unobtainable for heroin sales. The only chal-

275. Such regulation is legitimately carried on by the states under the police power, even if it may affect interstate commerce. The Minnesota Rate Cases, 230 U.S. 352, 432 (1913); Searsport Water Co., 118 Me. 382, 387, 108 A. 452, 454-55 (1919). In recent years there have been proposals for direct federal intervention in states' ratemaking. *See Electric Utility Rate Reform and Regulatory Improvement: Hearings on H.R. 12461, H.R. 2633 and H.R. 2650 (tits. VII and VIII), H.R. 6696, H.R. 10869, H.R. 11475, H.R. 12872 before the Subcomm. on Energy and Power of the House Comm. on Intrastate and Foreign Commerce*, 94th Cong., 2d Sess., pts. 1 & 2 (1976). The Public Utility Regulatory Policies Act, codified in part at 16 U.S.C.A. § 2601 (Cum. Supp. 1979), requires state commissions to consider a number of ratemaking options, including time-of-day pricing, seasonal rates, lifeline, as well as imposes restrictions on the procedures used in automatic adjustment clauses and in the inclusion of advertising expenses. State autonomy over rates, however, is specifically preserved. *Id.* at § 2627.

276. In such case a tax penalty would ordinarily be valid. Sunshine Coal Co. v. Adkins, 310 U.S. 381, 394 (1940).

277. United States v. Kahriger, 345 U.S. 22 (1953) (tax on persons engaged in business of receiving wagers); United States v. Sanchez, 340 U.S. 42 (1950) (tax on transfer of marijuana to unregistered person); Sonsinsky v. United States, 300 U.S. 506 (1937) (license tax on dealers in firearms).

278. United States v. Kahriger, 345 U.S. 22, 28 (1953). In *Kahriger,* the Court stated:

> Penalty provisions in tax statutes added for breach of regulation concerning activities in themselves subject only to state regulation have caused this Court to declare the enactments invalid. Unless there are provisions extraneous to any tax need, courts are without authority to limit the exercise of the taxing power. All the provisions of this excise are adapted to the collection of a valid tax.

Id. at 31 (footnote omitted). *See also* United States v. Sanchez, 340 U.S. 42, 44-45 (1950); Sonsinsky v. United States, 300 U.S. 506, 513 (1937).

279. 396 U.S. 87 (1969).

lenge to the statute was based on denial of the privilege against self-incrimination; an abuse of the taxing power was not directly at issue. Nevertheless, Justice Douglas, joined by Justice Black, dissented on the ground that the critical element of the statute had to be collection of the tax, which was impossible because the form was unavailable for sale of this particular drug. He seems to have been saying that the requisite taxing purpose was lacking because it was impossible for the government to gain any tax revenue.[280]

These cases are not closely on point with the taxing statutes considered here that do not involve the taxation of a criminal activity, but rather the prohibition of a perfectly lawful activity. It is at least possible to conclude, however, that a taxing measure must be capable of producing revenue to be sustained, particularly when it deals with regulation otherwise left to the state regulatory bodies.

It is doubtful whether normalization produces any additional taxable revenue at all, and meets the test of having a revenue purpose. Arguably, sections 167(*l*) and 46(f) produce revenue in that if a commission fails to order normalization the tax benefit is denied. It has been demonstrated, however, that by taking into account the rate base effects and the present worth of the tax payments to be generated over a period of time, normalization generates increased tax revenue only in high constant growth situations. Otherwise, it will generate less tax revenue than flow-through treatment.[281] Moreover, if there is a tax loss, it is actually the accelerated depreciation and investment tax credit that deprive the government of revenue. Normalization merely insures that the utility companies receive the monies that the Treasury has foregone.[282]

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280. *Id.* at 100. Moreover, Justice Douglas found it irrelevant that a flat ban on heroin sales might have been sustainable under the commerce clause since Congress had clearly enacted a taxing measure. *Id.* at 101. The majority rather cryptically indicated that the commerce clause would sustain the act and that the fact that the revenue obtained was "negligible" was of little importance; however, this must be regarded as dictum. *Id.* at 98 n.13.

281. Pollock, *The Effect of Alternative Regulatory Treatment of Tax Depreciation on Utility Tax Payments,* 26 NAT. TAX J. 43 (1973).

282. The "double loss" theory is discussed and shown to be imaginary. *See* notes 66-69 and accompanying text *supra. But see Accelerated Depreciation and State Ratemaking Policy: The Case of California,* 31 STAN. L.R. 265, 267 and 297 (1979), concluding that § 167(e) is valid based on a "logical if debatable relationship to congressional concerns for limiting revenue losses associated with accelerated depreciation."

Even if some revenue purpose can be found, however, the rationale of an older line of cases prohibiting regulation under the taxing power seems more appropriate. In those cases, it was held that Congress could not constitutionally interfere with legitimate activities carried on by the citizens of the states by enacting a penalty tax on activities left to state regulation.[283] In many of these instances later regulation of the activities in question undertaken by Congress under the commerce power was sustained.[284] These later decisions were in part attributable to a broader interpretation of the commerce power itself. But, if the older cases stand for anything, they indicate that Congress may not, by an exercise of the taxing power having only a partial regulatory effect, interfere in areas left to legitimate regulation by the states. If there is a doubt as to the validity of federal tax measures which support the state regulation[285] or which do not contradict any state law, the doubt should be even stronger when the legislation undermines the state law. In this instance, the tax does not fall on an activity such as selling heroin or engaging in illegal gambling, and a taxpayer may not easily avoid the tax by foregoing the prohibited activity.

The Supreme Court decisions with regard to the taxing power do not take us very far. Because of the earlier cases limiting the use of the taxing power, Congress has generally expanded the role of the national government in the federal system by legislation enacted under the commerce power and the Civil War Amendments. Nevertheless, the Supreme Court in *United States v. Butler*[286] suggested that the power of Congress under Article 1,

283. United States v. Constantine, 296 U.S. 287 (1935) (tax on sales of liquor forbidden by state or local law); Hill v. Wallace, 259 U.S. 44 (1922) (tax on grain sold by contract for future delivery except that sold on boards of trade as defined by act); Bailey v. Drexel Furniture Co., 259 U.S. 20 (1922) (excise tax on employer of child labor).

284. Wickard v. Filburn, 317 U.S. 111 (1942) (penalty for marketing agricultural production in excess of quota); United States v. Darby, 312 U.S. 100 (1941) (minimum wage and hour legislation including child labor standards sustained as to workers who produce goods for interstate commerce); Mulford v. Smith, 307 U.S. 38 (1939) (penalizing sale of agricultural products by warehousemen in excess of quota); Chicago Bd. of Trade v. Olsen, 262 U.S. 1 (1923) (regulation of boards of trade handling transaction in grain futures).

285. *See* United States v. Constantine, 296 U.S. 287 (1935).

286. United States v. Butler, 297 U.S. 1, 6 (1936). The power to buy and appropriate taxes for the general walfare has been referred to as the "spending power." G. GUNTHER & N. DOWLING, CONSTITUTIONAL LAW, CASES & MATERIALS 366 *passim* (8th ed. 1970). This title tends unduly to broaden the concept relating to the power by suggesting a limitation on the power of Congress to spend the tax monies, which limitation, of course, does not

Section 8, Clause 1 of the Constitution "to lay and collect Taxes . . . for the common defense and general welfare of the United States" might in some senses be broader than the commerce clause power, since the power to expend public monies for the general welfare was not interpreted as being limited by the direct grants of legislative power under the other clauses of Section 8.

The *Butler* case itself, however, limited the use of this power by holding invalid a tax on agricultural processors, the proceeds of which were to be used to pay farmers to reduce production, because such a plan to regulate local agricultural production invaded an area of regulation left to the states.[287] Although the *Butler* case can be criticized for the conclusion that the regulation of agricultural production was beyond federal control and reserved to the states, even the dissent recognized that the power to collect taxes for the general welfare could not be used to coerce action truly left to state control.[288] The difficulty is that neither *Butler* nor any subsequent case gives much useful guidance in the area between federal legislation that merely regulates individual conduct and that which interferes with matters more specifically left to state regulation.

The leading case is *Steward Machine Co. v. Davis,*[289] in which the Court sustained a federal excise tax on employment, ninety percent of which was credited back to the employers in states which adopted an unemployment compensation plan meeting certain standards set up by Congress. This case is distinguishable on several grounds. First, the social security scheme started with a tax and rewarded certain conduct by giving a credit. With regard to required normalization, Congress first gave the benefit and later took it away if the state regulators did not allow normalization. This might not be considered significant as an abstract matter, but the Court in *Steward Machine Co.* distinguished those cases in which "a tax dependent upon the conduct of the taxpayers, or the state in which they live, where the conduct to be stimulated or discouraged is unrelated to the fiscal need subserved by the tax in its normal operation . . . ."[290]

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exist. It might be more appropriate to refer to this power as the "general welfare" power because vague as this language may be it does connote some limitation and definition.

287. 297 U.S. at 68. As with the other taxing power cases, Congress eventually achieved a very similar regulation result that was upheld by the Court under the commerce power. Mulford v. Smith, 307 U.S. 38 (1939).

288. United States v. Butler, 297 U.S. 1, 87 (1936).

289. 301 U.S. 548 (1937).

290. *Id.* at 591.

When Congress has elected to give a tax benefit and then takes it back selectively, it is more difficult to find a relationship to any perceived fiscal need. With the normalization statutes there is not sufficient relationship between the tax conditioned activity and the "fiscal need subserved by the tax." Although tax collections under taxing statutes, as in *Steward Machine Co.*, go into the general treasury, the Court in *Steward* was careful to note the existence of a valid federal purpose—relief of unemployment—the cost of which would fall on the federal government if the states did not take on the burden.[291] Moreover, the tax credit in that case allowed the states to impose the cost of unemployment relief on the same employers who were relieved of the obligation to pay the federal tax.

The Court in *Steward Machine Co.* discussed at some length the national purpose of the Act.[292] Finding a legitimate national purpose to provide relief against unemployment, the Court then had to decide if there was any obstacle to the accomplishment of that purpose by encouraging the states to address it, rather than simply spending the federal dollars directly, which would in no way have infringed on the powers reserved to the states.

By comparison, it is difficult to find any valid federal purpose at all for the normalization statutes. Assuming that Congress can validly attempt to stimulate the economy by an overall grant to business firms in the form of tax reductions to match new equipment expenditures, that purpose must fail when applied to regulated monopoly corporations guaranteed a fair return on their investment. Even before the enactment of IRC sections 167(*l*) and 46(f), the tax benefits given the utilities did not achieve their alleged purpose of stimulating the economy. They resulted in either a reduction in rates, achieved by regulatory flow-through, or a windfall source of cash to utility shareholders, achieved by normalization, but did not legitimately affect the utility companies' decisions to build more plants.[293]

If, for purposes of argument, the existence of a valid federal purpose is conceded, there is still no indication that Congress intended to use the taxes to relieve those utilities that are required to use flow-through ratemaking and thus lose the tax benefit. In *Steward Machine Co.*, there was a real choice between

291. *Id.* at 590-91.
292. *Id.* at 596-99.
293. *See* notes 42-43 and accompanying text *supra*.

relief of the problem by use of the federal tax revenue or adoption of a state plan using the money which would otherwise go to pay federal taxes. In this instance there is no such option.

Although normalization may relieve Congress of the need to subsidize the utility companies in more direct ways, there is no evidence that Congress would do this if the states elected flow-through; to date it has not. Moreover, if a state insists on flow-through, it does not take on any financial or legal obligation to furnish such assistance, so that Congress has not as in *Steward Machine Co.* relieved the federal taxpayer of a burden.

Additionally, *Steward Machine Co.* stressed that the states were left not only the choice of whether to adopt an unemployment compensation plan, but also were granted a reasonable degree of freedom to exercise their own governmental judgment in setting up such a plan.[294] The legislation considered in *Steward Machine Co.*, while it put financial pressure on the states to take on a legislative duty they were not meeting, left some choices to the states and did not require them to violate any existing law. The hidden utility company revenues obtained by normalization force a state commission either to grant too high a return by including the unreal taxes as a cost of service or to disguise the activity by granting too low a regular rate of return to equalize the unfair charge. The first alternative violates existing independent statutory and constitutional protections by forcing ratepayers to pay confiscatory charges[295] and the second alternative makes it impossible for a reviewing court to determine if these standards have been applied.[296]

Congress has here invaded the state regulatory scheme in an area of regulation specifically left to the states by prior history and decision.[297] In doing so, it has given a tax benefit to those

294. 301 U.S. at 593-94.

295. See discussion in Part V.A. *supra.*

296. *See* note 259 and accompanying text *supra.*

297. The power of Congress to encroach upon state governmental activities as necessary to carry out appropriate federal activities is broader. In Oklahoma v. United States Civil Service Comm'n, 330 U.S. 127 (1947), the Court upheld the extension of the Hatch Act to state employees carrying out federal programs with federal monies. The forced termination of such a state employee because of his political activities was approved on the theory that Congress had the right to protect its programs by prohibiting persons carrying out the federal contracts from participating in politics. This power may encroach on the state's liberty to hire or elect who it pleases, but it does not interfere at all with state regulatory decisions. It is not discussed in detail because the attachment of this kind of condition to the use of federal money in a concededly valid federal program is not analogous to the federal tax legislation in question.

utilities that are allowed to charge illegal rates to their taxpayers and denied it to those that are required to charge rates in the usual and lawful manner. For this reason, it is an invalid exercise of the taxing power. Any remaining doubt must be removed by considering that the resulting rates are unconstitutional independently because they violate due process and equal protection duties as set forth in Part V.A.

VI. Conclusion

The purpose of this article has been to demonstrate that certain ratemaking practices, included under the broad denomination of normalization, violate fundamental principles of ratemaking by allowing fictitious expenses to be charged to the current ratepayers. This destroys the validity of the ratemaking formula that has been in general use for almost a century. While it may be possible to replace this formula, it certainly would not be an easy task. Almost all public utility ratemaking law, whether statutory, administrative or judicial, is predicated on its existence. The inclusion of fictitious costs cannot result in anything but unreviewable ratemaking orders. Of course, the courts would retain the power to reverse decisions, but any standard of rationality would become impossible. There is very little to say on behalf of normalization that could justify the imposition of such chaos. There is nothing that normalization does which cannot be done by direct and lawful means, such as the adjustment of the rate of return. For this reason, the practice should be disapproved and abandoned; legislation requiring it should be repealed as unwise. If not so repealed, the legislation must eventually be invalidated as requiring unjust and unreasonable rates and as unduly inhibiting the states in one of their primary traditional functions.